



APPENDIX

Supreme Court, U. S.

FILED

JUL 28 1976

MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States
OCTOBER TERM, 1975

No. 75-1260

FIRST RAILROAD & BANKING COMPANY OF GEORGIA,
Petitioner

—v.—

UNITED STATES OF AMERICA

**ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE FIFTH CIRCUIT**

**PETITION FOR A WRIT OF CERTIORARI FILED MARCH 5, 1976
CERTIORARI GRANTED MAY 24, 1976**



In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1260

FIRST RAILROAD & BANKING COMPANY OF GEORGIA,
Petitioner

—v.—

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE FIFTH CIRCUIT

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UNITED STATES DISTRICT COURT

Civil Docket 1738

FIRST RAILROAD & BANKING COMPANY OF GEORGIA

vs.

THE UNITED STATES OF AMERICA

DOCKET ENTRIES

1972

Aug. 2 Filing and entering Original Complaint.

Summons returnable 60 days.

Copy of complaint mailed to Judge Alaimo.

Aug. 11 Filing Marshal's Return on Service. Served
8-8-1972. MC \$3.00

Oct. 4 Filing and Entering Answer of Defendant.

Jan. 5/73 Pre-Trial Hearing held this date, Pre-Trial
Order to be consolidated and filed within 2 weeks.
Trial set for Week of 2-19-72.

Jan. 9 Filing and Entering Deposition of Lawrence
Earls.

Jan. 31 Filing and Entering Deposition of Mr. Berry
McIntyre.

Jan. 31 Filing and Entering Deposition of Mr. Fleming
Love.

Feb. 1 Filing and Entering Deposition of Mr. E. R.
Phillips.

Feb. 9 Filing and entering Notice to take Deposition
of James R. Harper, Esquire.

Feb. 15 Filing and Entering Deposition of H. B. Sturte-
vant.

- Feb. 19 Case tried this date, as a Non-Jury Trial. Findings of facts and Conclusions of Law to be mailed to the Court in Brunswick by 3-2-73 by counsel for all parties, Order to be entered at later date.
- Mar. 1 Filing and Entering Plaintiff's Findings of Fact and Conclusions of law.
- Feb. 19 Filing and Entering Stipulation of Facts as to Procedural Facts, Substantive Facts. etc. Filing and entering Pre-Trial Order.
- Apr. 9 Filing and Entering Memorandum Opinion, Judgment in favor of the Plaintiff, entry of Judgment withheld, pending proper determination of amounts due plaintiff.
- June 5 Filing and Entering Final Judgment.
- June 18 Filing Objections to Bill of Costs of Plaintiff.
- June 22 Filing Brief in Support of Objections to Bill of Costs of Plaintiff.
- July 30 Filing Brief in Support of Plaintiff's Bill of Costs.
- Aug. 1 Filing and Entering Notice of Appeal. (Copy mailed to C/A, New Orleans, Opposing Counsel, Judge Alaimo and Hdqr. Savannah, Ga.
- Aug. 20 Filing and entering Transcript of Trial held in U.S. District Court, Augusta Division on Feb. 19, 1973.
- Aug. 21 Filing Order sustaining Defendant's Objections to Plaintiff's Bill of Costs.

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF GEORGIA
AUGUSTA DIVISION

Civil Action No. 1738

FIRST RAILROAD & BANKING COMPANY OF GEORGIA,
PLAINTIFF

vs.

THE UNITED STATES OF AMERICA, DEFENDANT

(Filed: August 2, 1972)

COMPLAINT

First Railroad & Banking Company of Georgia, a Georgia corporation, brings this action against the United States of America to recover federal income taxes illegally assessed and collected for the years 1961 through 1964, inclusive. In support of this suit for refund, the plaintiff respectfully shows the Court as follows:

1.

The defendant herein is the United States of America and this action arises under the Internal Revenue Service Laws of the United States and is within the jurisdiction of the Court under authority of Title 28 Section 1346 (a) (1) of the United States Code.

2.

Plaintiff maintains its principal offices at 699 Broad Street, Augusta, Georgia 30902, and these offices are within the geographical boundaries for venue of this Division of Court.

3.

The plaintiff duly filed their United States Corporation Income Tax Return with the District Director of Internal Revenue, Atlanta, Georgia, for each of the taxable calendar years 1961 through 1964, inclusive.

4.

The defendant is indebted to the plaintiff as a result of corporation income tax and interest erroneously assessed and collected as follows:

ERRONEOUS ASSESSMENT AND COLLECTION

<u>Calendar Year</u>	<u>Income Tax</u>	<u>Interest Paid</u>	<u>Total</u>
1961	\$25,340.29	\$11,393.00	\$36,733.29
1962	12,555.98	4,891.82	17,447.80
1963	17,494.51	5,776.19	23,270.70
1964	47,264.31	12,742.46	60,006.77

Note: There is an investment tax credit carryback from the year 1967 to the taxable year 1964 in the amount of \$26,105.13, but this amount is not subject to determination in this proceeding.

5.

For each of the years 1961 through 1964, inclusive, the plaintiff, on or about March 15, 1971, filed timely Claims for Refund on United States Treasury Forms 843 with the District Director of Internal Revenue Service for the District of Georgia.

6.

A copy of each Claim for Refund is attached to this Complaint marked Exhibit "A" for 1961, Exhibit "B" for 1962, Exhibit "C" for 1963, Exhibit "D" for 1964. These Claims with each and every part thereof, including a supplement to each, are incorporated in this Complaint by reference the same as if set out in full.

7.

Neither the defendant nor any of its duly delegated agents has formally rejected the Claims for Refund attached hereto as Exhibits A, B, C, and D, but more than six (6) months have elapsed since the Claims were filed on March 15, 1971.

8.

First of Georgia Life Insurance Company, formerly known as First of Georgia Credit Life Company, filed

individual corporate tax returns for each of the years 1961 through 1964, inclusive. First of Georgia Life Insurance Company and its predecessor are hereinafter referred to as "The Life Company".

9.

"The Life Company" was, at all times during 1961 through 1964, inclusive, a life insurance company within the statutory definition of Section 801, taxable under Section 802, of the Internal Revenue Code of 1954.

10.

The life insurance reserves of "The Life Company" as defined in Section (b) of Section 801 plus unpaid losses and unearned premiums under Sub-section (a) (2) of Section 801 constitutes more than fifty (50%) percent of the total reserves as defined in Subsection (c) of Section 801. For each of the years 1961 through 1964, inclusive, the ratio of life insurance reserves to total reserves, under the statutory formula, was:

<u>Year</u>	<u>Statutory Ratio</u>
1961	50.39%
1962	51.63%
1963	50.32%
1964	51.69%

11.

The income of "The Life Company" cannot be added to the income as reported in the consolidated return of First Railroad & Banking Company of Georgia because "The Life Company" was not an "includible corporation", within the meaning of Section 1504(b) of the Internal Revenue Code of 1954.

12.

The net income of "The Life Company" is not includible as an element of consolidated income of First Railroad & Banking Company of Georgia. The net income of "The Life Company" should be eliminated from

plaintiff's income for each of the years 1961 through 1964, inclusive, as follows:

<u>Year</u>	<u>Amount</u>
1961	\$ 73,492.26
1962	44,653.71
1963	63,416.35
1964	145,080.01

13.

The life insurance reserves of "The Life Company" properly computed upon the basis of mortality tables, at the end of each of the years 1960 through 1964, follow:

<u>Year Ended 12/31</u>	<u>Amount</u>
1960	\$ 70,051.00
1961	80,718.00
1962	92,823.00
1963	137,325.00
1964	166,471.00

14.

During each of the years 1961 through 1964, inclusive, and at all times pertinent herein, "The Life Company" sold various health and accident insurance policies as a primary insurer.

15.

On or about December 31, 1961, "The Life Company" entered into a reinsurance treaty with First of Georgia Insurance Company providing for the reinsurance of various health and accident insurance policies written by "The Life Company" as primary insurer. This reinsurance agreement was motivated by a sound business purpose and said agreement was negotiated on the basis of terms which were competitive with similar types and similar circumstances of reinsurance in the industry. As a result of this reinsurance treaty, the following amounts should be eliminated from the total reserves of "The Life Company" at the end of each year in the following amounts:

<u>Year</u>	<u>Amount</u>
1961	\$ 80,272.00
1962	148,659.00
1963	237,726.00
1964	260,251.00

WHEREFORE, the plaintiff prays:

(a) That process issue requiring the defendant to answer the Complaint within the time prescribed by law;

(b) That plaintiff have judgment against the United States of America in the following amounts:

<u>Year Ended</u>	<u>Amount</u>
1961	\$36,733.29
1962	17,447.80
1963	23,270.70
1964	60,006.77

The plaintiff also claims costs and interest as provided by law on the above amounts.

/s/ James R. Harper
James R. Harper
Attorney for Plaintiff

JOHNSON, HARPER, DANIEL, WARD & STANFIELD
1526 Fulton National Bank Building
Atlanta, Georgia 30303
524-5626

[Certificate of Service Omitted]

Form 843

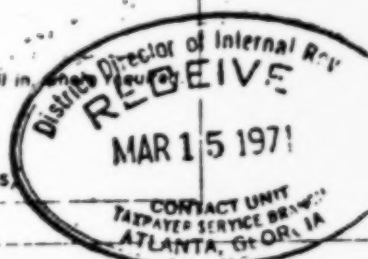
(Rev. Dec. 1970)
Department of the Treasury
Internal Revenue Service

Claim

Director's Stamp
(Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in, one of the following:

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).



Please Type or Print Plainly

Name of taxpayer or purchaser of stamps

First Railroad & Banking Company of Georgia

Number and street

699 Broad Street

City or town, State, and ZIP code

Augusta, Georgia 30902

Fill in applicable items—Use attachments if necessary

a. Your social security number

Wife's number, if joint return

b. Employer identification number (if any)

58-6017673

c. Internal Revenue Service office where return (if any) was filed

Southeastern

d. Name and address shown on return, if different from above

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year

f. Kind of tax

From January 1, 1961 to December 31, 1961

Income

g. Amount of assessment

\$333,543.52

Dates of payment

March 15, 1962; May 20, 1966; September 8, 1969

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below)

j. Amount to be abated (not applicable to income, estate, or gift taxes)

* \$35,733.29 plus int. ;

k. The claimant believes that this claim should be allowed for the following reasons:

Attached hereto is a continuation page and the facts stated thereon are covered by the oath at the bottom of this page.

* Analysis of Block 1.:

Overpayment of tax

\$25,340.29

Plus interest assessed: paid

11,393.00

Total overpayment at interest

\$36,733.29

In the alternative the taxpayer claims such other and greater amount as may be due plus interest provided by law.

Computation of Income Tax Refund

Income Tax

1 Tax withheld	
2 Estimated tax paid	313,203.23
3 Tax paid with original return	25,340.29
4 Any additional income tax paid	338,543.52
5 Total tax paid (add lines 1-4)	295,123.92
6 Less: Your computation of correct tax	43,425.60
7 Amount of overpayment	18,003.31
8 Amount previously refunded	
9 Net overpayment (enter in item 1 above)	25,340.29

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed

Senior Vice President

Dated

March 15, 1971

See instructions on reverse.

Form 843 (Rev. 12-70)

BEST COPY AVAILABLE



First Railroad & Banking Company of Georgia

Form 843 continuation sheet.

- k. 1. The Revenue Agent has erroneously determined that the First of Georgia Credit Life Company is not a life insurance company within the statutory definition of Section 801 of the Internal Revenue Code of 1954. In this connection the Revenue Agent failed to recognize that the life insurance reserves as defined in subsection (b) of Section 801 plus unpaid losses and unearned premiums under subsection (a) (2) of Section 801 comprised more than 50% of the total reserves as defined in subsection (c) of Section 801.

2. As a result of the agent's failure to recognize that the First of Georgia Credit Life Company was a life insurance company within the definition of Section 801, the agent has consolidated the income of First of Georgia Credit Life Company in the consolidated income tax return of First Railroad & Banking Company, the taxpayer herein.

3. First of Georgia Credit Life Company is not an "Includible Corporation" within the meaning of Section 1504(b) of the Internal Revenue Code of 1954, and the agent may not add the income of that corporation to the income of the consolidated return filed by First Railroad & Banking Company.

4. In the computation of qualifying reserves, the Commissioner erroneously takes into account gross unearned accident and health insurance premiums without giving effect to the contracts and the losses thereon which had been ceded to the parent in a valid arm's length transaction.

5. First of Georgia Credit Life Company is not an Includible Corporation because it is a life insurance company taxable under the provisions of Section 802 of the Internal Revenue Code of 1954. The following amount should be eliminated from the computation of income for the First Railroad & Banking Company, of Georgia for the year 1961:

<u>Year</u>	<u>Amount</u>
1961	\$73,492.26

6. The reinsurance of accident and health insurance premiums and risks was a valid business transaction founded upon a sound business purpose usual in the insurance business. *Alinco Life Insurance Company v. U.S.* (Ct Cl 1967) 19 AFTR 2d 745; Rev Rul 68-185, 1968-1 CB 317.

Form **843**(Rev. Dec. 1970)
Department of the Treasury
Internal Revenue Service**Claim**Director's Stamp
(Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).

Please Type or Print Plainly

Name of taxpayer or purchaser of stamps

First Railroad & Banking Company of Georgia

Number and street

699 Broad Street

City or town, State, and ZIP code

Augusta, Georgia 30902

Fill in applicable items—Use attachments if necessary

a. Your social security number

Wife's number, if joint return

b. Employer identification number (if any)

58-6017673

c. Internal Revenue Service office where return (if any) was filed

d. Name and address shown on return, if different from above

Southeastern

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year f. Kind of tax

From **January 1** 19. **62** to **December 31** 19. **62** **Income**

g. Amount of assessment

Dates of payment

\$ 315,311.56**1962, 1963 and Sept. 8, 1969**

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below)

j. Amount to be abated (not applicable to income, estate, or gift taxes)

***\$17,447.20 plus int. ***

k. The claimant believes that this claim should be allowed for the following reasons:

Attached hereto is a continuation page and the facts stated thereon are covered by the oath at the bottom of this page.

***Analysis of Block i:**

Overpayment of tax

12,555.98

Plus interest assessed and paid

4,891.82

Total overpayment at interest

\$17,447.80

In the alternative, the taxpayer claims such other and greater amount as may be due plus interest provided by law.

Computation of Income Tax Refund

Income Tax

1 Tax withheld	
2 Estimated tax paid	
3 Tax paid with original return	298,042.82
4 Any additional income tax paid	17,268.74
5 Total tax paid (add lines 1-4)	315,311.56
6 Less: Your computation of correct tax	288,131.40
7 Amount of overpayment	27,180.16
8 Amount previously refunded	14,624.18
9 Net overpayment (enter in item i above)	12,555.98

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed

Senior Vice PresidentDated **March 15,** 19**71**

See instructions on reverse

Form **843** (Rev. 12-70)**BEST COPY AVAILABLE**



First Railroad & Banking Company of Georgia

Form 843 for Calendar Year 1962, continuation sheet.

- k. 1. The Revenue Agent has erroneously determined that the First of Georgia Credit Life Company is not a life insurance company within the statutory definition of Section 801 of the Internal Revenue Code of 1954. In this connection the Revenue Agent failed to recognize that the life insurance reserves as defined in subsection (b) of Section 801 plus unpaid losses and unearned premiums under subsection (a)(2) of Section 801 comprised more than 50% of the total reserves as defined in subsection (c) of Section 801.

2. As a result of the agent's failure to recognize that the First of Georgia Credit Life Company was a life insurance company within the definition of Section 801, the agent has consolidated the income of First of Georgia Credit Life Company in the consolidated income tax return of First Railroad & Banking Company, the taxpayer herein.

3. First of Georgia Credit Life Company is not an "Includible Corporation" within the meaning of Section 1504(b) of the Internal Revenue Code of 1954, and the agent may not add the income of that corporation to the income of the consolidated return filed by First Railroad & Banking Company.

4. In the computation of qualifying reserves, the Commissioner erroneously takes into account gross unearned accident and health insurance premiums without giving effect to the contracts and the losses thereon which had been ceded to the parent in a valid arm's length transaction.

5. First of Georgia Credit Life Company is not an Includible Corporation because it is a life insurance company taxable under the provisions of Section 802 of the Internal Revenue Code of 1954. The following amount should be eliminated from the computation of income for the First Railroad & Banking Company of Georgia for the year 1962:

<u>Year</u>	<u>Amount</u>
1962	\$44,653.71

6. The reimbursement of accident and health insurance premiums and risks was a valid business transaction founded upon a sound business purpose usual in the insurance business. *Alinco Life Insurance Company v. U.S.* (Ct Cl 1967) 19 AFTR 2d 745; Rev Rul 68-185, 1968-1 CB 317.

Form **843**(Rev. Dec. 1970)
Department of the Treasury
Internal Revenue Service**Claim**Director's Stamp
(Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).

Please Type or Print Plainly

Name of taxpayer or purchaser of stamps

First Railroad & Banking Company of Georgia

Number and street

699 Broad Street

City or town, State, and ZIP code

Augusta, Georgia 30902

Fill in applicable items—Use attachments if necessary

a. Your social security number

Wife's number, if joint return

b. Employer identification number (if any)

58-6017673

c. Internal Revenue Service office where return (if any) was filed

d. Name and address shown on return, if different from above

Southeastern

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year

f. Kind of tax

From **January 1** 19 **63** to **December 31** 19 **63****Income**

g. Amount of assessment

Dates of payment

\$ 122,564.06**1963, 1964 and September, 1969**

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below)

j. Amount to be abated (not applicable to income, estate, or gift taxes)

***\$23,270.70 plus int. :**

k. The claimant believes that this claim should be allowed for the following reasons:

Attached hereto is a continuation page and the facts stated thereon are covered by the oath at the bottom of this page.

***Analysis of Block 1:**

Overpayment of tax	\$17,494.51
Plus interest assessed and paid	5,776.19
Total overpayment at interest	\$23,270.70

In the alternative, the taxpayer claims such other and greater amount as may be due plus interest provided by law.

Computation of Income Tax Refund**Income Tax**

1 Tax withheld	
2 Estimated tax paid	
3 Tax paid with original return	14,962.34
4 Any additional income tax paid	107,601.72
5 Total tax paid (add lines 1-4)	122,564.06
6 Less: Your computation of correct tax	105,069.55
7 Amount of overpayment	17,494.51
8 Amount previously refunded	
9 Net overpayment (enter in item i above)	17,494.51

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed

Senior Vice President

Dated

March 15, 19 71

See instructions on reverse.

Form 843 (Rev. 12-70)



First Railroad & Banking Company of Georgia

Form 843 for Calendar year 1963, continuation sheet.

k. 1. The Revenue Agent has erroneously determined that the First of Georgia Credit Life Company is not a life insurance company within the statutory definition of Section 801 of the Internal Revenue Code of 1954. In this connection the Revenue Agent failed to recognize that the life insurance reserves as defined in subsection (b) of Section 801 plus unpaid losses and unearned premiums under subsection (a)(2) of Section 801 comprised more than 50% of the total reserves as defined in subsection (c) of Section 801.

2. As a result of the agent's failure to recognize that the First of Georgia Credit Life Company was a life insurance company within the definition of Section 801, the agent has consolidated the income of First of Georgia Credit Life Company in the consolidated income tax return of First Railroad & Banking Company, the taxpayer herein.

3. First of Georgia Credit Life Company is not an "Includible Corporation" within the meaning of Section 1504(b) of the Internal Revenue Code of 1954, and the agent may not add the income of that corporation to the income of the consolidated return filed by First Railroad & Banking Company.

4. In the computation of qualifying reserves, the Commissioner erroneously takes into account gross unearned accident and health insurance premiums without giving effect to the contracts and the losses thereon which had been ceded to the parent in a valid arm's length transaction.

5. First of Georgia Credit Life Company is not an Includible Corporation because it is a life insurance company taxable under the provisions of Section 802 of the Internal Revenue Code of 1954. The following amount should be eliminated from the computation of income for the First Railroad & Bank Company of Georgia for the year 1963:

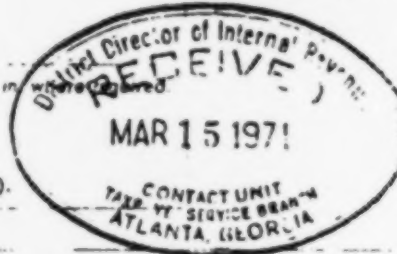
<u>Year</u>	<u>Amount</u>
1963	\$63,416.35

6. The reinsurance of accident and health insurance premiums and risks was a valid business transaction founded upon a sound business purpose usual in the insurance business. *Alinco Life Insurance Company v. U.S.* (Ct Cl 1967) 19 AFTR 2d 745; Rev Rul 68-185, 1968-1 CB 317.

Form 843

(Rev. Dec. 1970)
Department of the Treasury
Internal Revenue Service

Claim

Director's Stamp
(Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).

Please Type or Print Plainly

Name of taxpayer or purchaser of stamps

First Railroad & Banking Company of Georgia

Number and street

699 Broad Street

City or town, State, and ZIP code

Augusta, Georgia 30902

Fill in applicable items—Use attachments if necessary

- a. Your social security number _____ Wife's number, if joint return _____ b. Employer identification number (if any) _____

58-6017673

- c. Internal Revenue Service office where return (if any) was filed _____ d. Name and address shown on return, if different from above _____

Southeastern

- e. Period—If for tax reported on annual basis, prepare separate form for each taxable year _____ f. Kind of tax _____

From January 1, 1964, to December 31, 1964 Income

- g. Amount of assessment _____ Dates of payment _____

\$ 162,373.33 June, 1966, September, 1969

- h. Date stamps were purchased from Government _____ i. Amount to be refunded (If income tax, complete computation below) _____ j. Amount to be abated (not applicable to income, estate, or gift taxes) _____

*\$ 86,111.90

- k. The claimant believes that this claim should be allowed for the following reasons:

Attached hereto is a continuation page and the facts stated thereon are covered by the oath at the bottom of this page. Computation of investment credit is attached.

***Analysis of Block 1: Overpayment of tax** \$47,264.31
Plus Interest assessed and paid 12,742.46
Total overpayment of interest \$60,006.77
Add: Investment tax credit carryback-1967 26,105.13
Total overpayment \$86,111.90
In the alternative the claimant claims such other and greater amount as may be due plus interest provided by law.

Computation of Income Tax Refund

Income Tax

1 Tax withheld	10,800.89
2 Estimated tax paid	151,485.44
3 Tax paid with original return	162,373.33
4 Any additional income tax paid	115,100.02
5 Total tax paid (add lines 1-4)	47,264.31
6 Less: Your computation of correct tax	
7 Amount of overpayment	
8 Amount previously refunded	
9 Net overpayment (enter in item 1 above)	47,264.31

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed

Senior Vice President

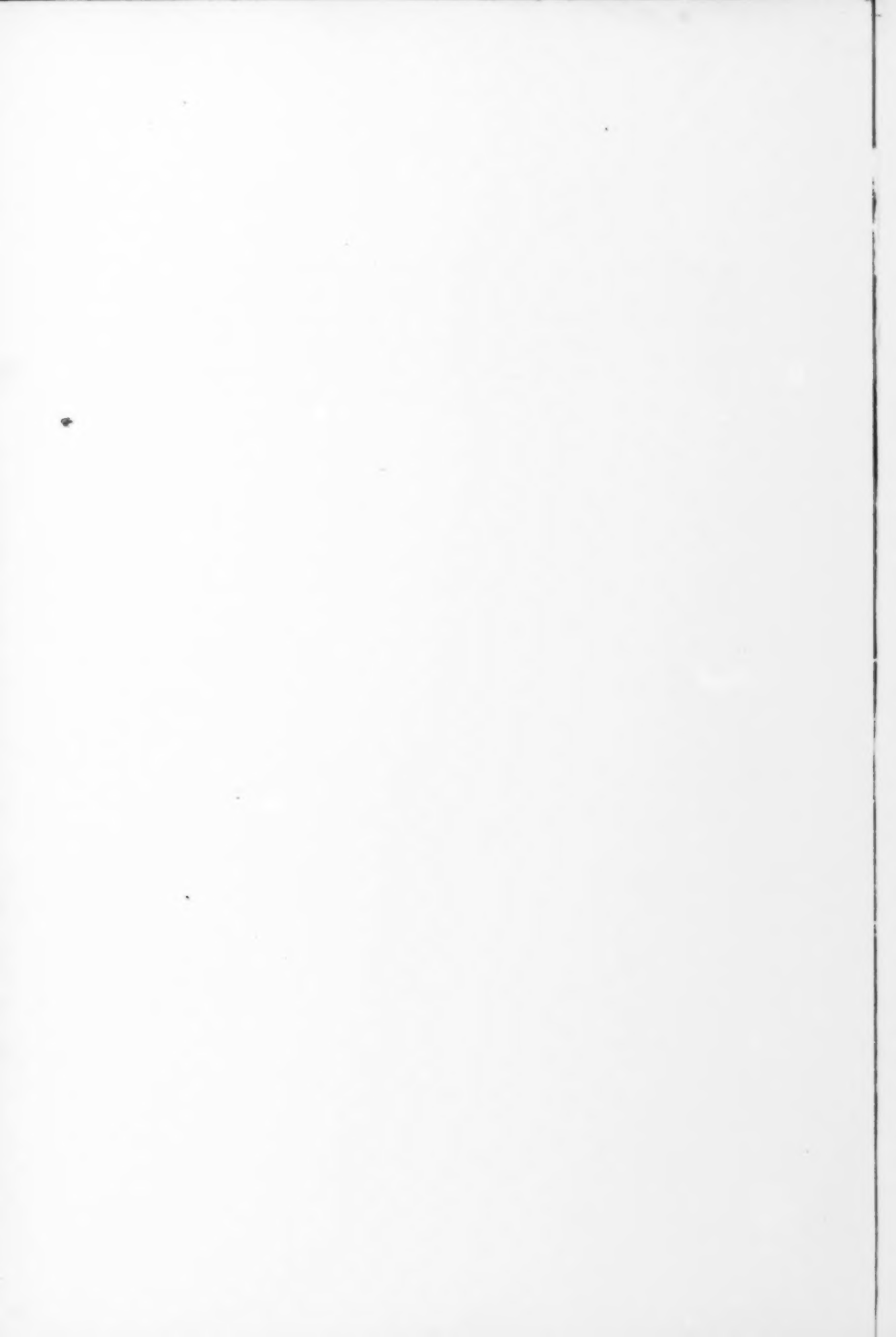
Dated

March 15, 1971

See instructions on reverse.

Form 843 (Rev. 12-70)

BEST COPY AVAILABLE



First Railroad & Banking Company of Georgia

Form 843 for Calendar Year 1964, continuation sheet.

k. 1. The Revenue Agent has erroneously determined that the First of Georgia Credit Life Company is not a life insurance company within the statutory definition of Section 801 of the Internal Revenue Code of 1954. In this connection the Revenue Agent failed to recognize that the life insurance reserves as defined in subsection (b) of Section 801 plus unpaid losses and unearned premiums under subsection (a)(2) of Section 801 comprised more than 50% of the total reserves as defined in subsection (c) of Section 801.

2. As a result of the agent's failure to recognize that the First of Georgia Credit Life Company was a life insurance company within the definition of Section 801, the agent has consolidated the income of First of Georgia Credit Life Company in the consolidated income tax return of First Railroad & Banking Company, the taxpayer herein.

3. First of Georgia Credit Life Company is not an "Includible Corporation" within the meaning of Section 1504(b) of the Internal Revenue Code of 1954, and the agent may not add the income of that corporation to the income of the consolidated return filed by First Railroad & Banking Company.

4. In the computation of qualifying reserves, the Commissioner erroneously takes into account gross unearned accident and health insurance premiums without giving effect to the contracts and the losses thereon which had been ceded to the parent in a valid arm's length transaction.

5. First of Georgia Credit Life Company is not an Includible Corporation because it is a life insurance company taxable under the provisions of Section 802 of the Internal Revenue Code of 1954. The following amount should be eliminated from the computation of income for the First Railroad & Banking Company of Georgia for the year 1964:

<u>Year</u>	<u>Amount</u>
1964	\$145,080.01

6. The reinsurance of accident and health insurance premiums and risks was a valid business transaction founded upon a sound business purpose usual in the insurance business. *Alinco Life Insurance Company v. U.S.* (Ct Cl 1967) 19 AFTR 2d 745; Rev Rul 68-185, 1968-1 CB 317.

FIRST RAILROAD & BANKING COMPANY OF GEORGIA
RECOMPUTATION OF INVESTMENT CREDIT—1964
ADJUSTED FOR CARRYBACK OF 1967 UNUSED
INVESTMENT CREDIT

				Schedule 4
Qualified Investment in New or Used Property:				
	Life Years	Cost	Applicable Percentage	Qualified Investment
New Property				
1964	4 to 6	\$ 6,223.86	33-1/3	\$ 2,074.62
	8 or more	405,966.16	100	405,966.16
Total Qualified Investment				\$408,040.78
Tentative Investment Credit (7% of Qualified Investments)				\$ 28,562.85
Add: Carryback of Unused Credits from 1967—Schedule 1				26,105.13
Total				\$ 54,667.98
Income Tax per claim before tax credit				\$143,671.87

LIMITATION BASED ON AMOUNT OF TAX

Income Tax or \$25,000, whichever is lesser	\$ 25,000.00
25% of the Excess of Income Tax over \$25,000	29,667.98
Total Limitation	\$ 54,667.98
Investment Credit (as recomputed including carryback)	\$ 54,667.98

**FIRST RAILROAD & BANKING COMPANY OF GEORGIA
RECALCULATION OF INVESTMENT TAX CREDIT
TAXABLE YEAR 1967**

Schedule 1

	<u>Original</u>	<u>Corrected</u>	<u>Corrected Qualified Investment</u>
New Property			
4-5 Year Life	\$ 75,880.46	\$ 38,620.05	\$ 12,873.35
6-7 Year Life	8,025.00	8,025.00	5,350.00
8 or more years	1,262,481.42	1,299,759.88	1,299,759.83
Used Property			
8 or more years	50,000.00	50,000.00	50,000.00
Suspension Period Property			
4-5 Year Life	1,974.00	1,974.00	(658.00)
8 or more years	56,467.94	56,467.94	(56,467.94)
Allowable Suspension Period Property Investment			20,000.00
Total Qualified Investment			<u>\$1,330,857.24</u>
Investment Tax Credit as Recalculated			\$ 93,160.00
Investment Tax Credit Utilized in 1967			35,787.70
Investment Tax Credit Carry-back			<u>\$ 57,372.30</u>
Carry-back to: 1964			\$ 26,105.13
1965			31,267.17
			<u><u>\$ 57,372.30</u></u>

[Number and Title Omitted]

[Filed: October 4, 1972]

ANSWER

The defendant, United States of America, by its attorney, R. Jackson B. Smith, Jr., United States Attorney for the Southern District of Georgia, for its answer to the complaint herein admits, denies, and alleges as follows:

Admits the allegations contained in the first unnumbered paragraph of the complaint, except denies that any Federal income taxes were illegally assessed or collected.

1. Admits the allegations contained in paragraph 1.
2. Is presently without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 2.
3. Admits the allegations contained in paragraph 3.
4. Denies the allegations contained in paragraph 4, except is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in the last sentence of that paragraph.
5. Admits the allegations contained in paragraph 5.
6. Admits the allegations contained in paragraph 6, except denies each allegation contained in Exhibits A, B, C and D of the complaint not otherwise admitted in this answer.
7. Denies the allegations contained in paragraph 7, except admits that more than six months have elapsed since plaintiff's claims for refund were filed.
8. Admits the allegations contained in paragraph 8.
9. Denies the allegations contained in paragraph 9.
10. Denies the allegations contained in paragraph 10.
11. Denies the allegations contained in paragraph 11.
12. Denies the allegations contained in paragraph 12.
13. Is presently without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 13.

14. Is presently without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 14.

15. Is presently without knowledge or information sufficient to form a belief as to the truth of the allegations contained in the first and second sentences of paragraph 15. Denies the allegations contained in the third sentence.

WHEREFORE, defendant prays that judgment be entered in its favor, dismissing plaintiff's complaint, allowing the defendant its costs, and for such other and further relief as this Court may deem just and proper.

R. JACKSON B. SMITH, JR.
United States Attorney

By: /s/ Edmund A. Booth, Jr.
Assistant United States Attorney

[Number and Title Omitted]

[Filed: February 19, 1973]

STIPULATION OF FACTS

It is hereby stipulated that, for the purpose of this case, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part hereof except as otherwise indicated, subject to the right of either party to object to the admission of such statements or exhibits in evidence on the grounds of materiality or relevancy.

PROCEDURAL FACTS

1. For each year 1961 through 1964, plaintiff timely filed a consolidated U. S. Corporation Income Tax Return (Form 1120) with the Internal Revenue Service. Extracts of those returns are attached hereto as Exhibit 1-4. Such returns included the taxable income of the affiliated group of corporations of which plaintiff was a common parent except they did not include the taxable income of First of Georgia Life Insurance Company (formerly First of Georgia Credit Life Company) (hereinafter "Georgia Credit Life"), in the plaintiff's consolidated corporation income tax return. The taxes shown to be due on the returns were paid in full.

2. For each year 1961 through 1964, Georgia Credit Life timely filed a U. S. Life Insurance Company Income Tax Return (Form 1120 L), copies of which are attached hereto as Exhibits 5-8. On such returns Georgia Credit Life computed its income tax on the basis that it qualified as a life insurance company. The tax shown to be due on such returns was paid in full.

3. By letter dated April 21, 1969, the Internal Revenue Service sent plaintiff a notice of deficiency in Federal corporate income taxes in the aggregate amount of \$119,080.11 for the taxable years 1961 through 1964. A

copy of the notice of deficiency is attached hereto as Exhibit 9. The deficiencies were based on, among other things, the determination of the Internal Revenue Service that plaintiff should have included in its consolidated return the taxable income of Georgia Credit Life and that such taxable income should have been computed under Section 832, Internal Revenue Code of 1954, on the ground that Georgia Credit Life did not qualify as a life insurance company.

The taxable income of Georgia Credit Life which was added to plaintiff's taxable income as a result of the determination that Georgia Credit Life was not a life insurance company was as follows:

<u>Year</u>	<u>Amount</u>
1961	\$ 73,492.26
1962	44,653.71
1963	63,416.35
1964	145,080.01

4. On September 9, 1969, plaintiff paid to the Internal Revenue Service as additional income taxes and interest the following amounts for the years in suit:

<u>Year</u>	<u>Deficiency</u>	<u>Interest</u>	<u>Total</u>
1961	\$ 25,340.29	\$11,063.45	\$ 36,403.74
1962	17,268.74	6,384.15	23,652.89
1963	17,579.27	5,314.38	22,893.65
1964	58,891.81	16,768.97	75,660.78
	<u>\$119,080.11</u>	<u>\$39,530.95</u>	<u>\$158,611.06</u>

5. On March 15, 1971, plaintiff filed timely claims for refund with the District Director of Internal Revenue for the District of Georgia in the following amounts:

Year	Tax	Interest	Total
1961	\$ 25,340.29	\$11,393.00	\$ 36,733.29
1962	12,555.98	4,891.82	17,447.80
1963	17,494.51	5,776.19	23,270.70
1964*	<u>47,264.31</u>	<u>12,742.46</u>	<u>60,006.77</u>
	\$102,655.09	\$34,803.47	\$137,458.56

6. On May 10, 1972, the District Director of Internal Revenue sent plaintiff a statutory notice of claim disallowance, stating that the aforesaid claim for refund had been disallowed.

7. On August 2, 1972, plaintiff filed a timely complaint demanding recovery of the following amounts, plus statutory interest thereon:

Year	Amount
1961	\$ 36,733.29
1962	17,447.80
1963	23,270.70
1964	<u>60,006.77</u>
	\$137,458.56

8. The sole issue in this action is whether the action of the Internal Revenue Service in increasing the consolidated taxable income of plaintiff and its subsidiaries by the net income from Georgia Credit Life computed as if Georgia Credit Life were not a life insurance company was erroneous or illegal. The other adjustments to said consolidated income made by the Internal Revenue Service have been settled by agreement of the parties and are not in dispute.

9. If the Court finds that Georgia Credit Life was not a life insurance company as defined by Section 801 (a), Internal Revenue Code of 1954, then Georgia Credit

* Plaintiff also claimed for 1964 a refund of taxes in the amount of \$26,105.13 for an investment tax credit carryback from 1967. This issue is not before the court.

Life's net income was properly computed by the Internal Revenue Service and was includible in the consolidated taxable income of plaintiffs and its subsidiaries and plaintiff is entitled to no recovery in this action.

10. If the Court finds that Georgia Credit Life was a life insurance company as defined by Section 801(a), then Georgia Credit Life's income should not be includible in the aforesaid consolidated income of plaintiff and its subsidiaries for 1961 through 1964, inclusive. If the Court finds that Georgia Credit Life was a life insurance company, the Internal Revenue Service will recompute plaintiff's taxable income and the refund due by excluding the taxable income of Georgia Credit Life therefrom and by including for the year 1963 intercorporate dividends of \$7,500 from Georgia Credit Life net of the dividends received deduction. Such computation will be subject to the review and approval of plaintiff. In the event of disagreement on the computation between the parties, the parties will submit the matter to the Court for a decision.

11. The issue whether Georgia Credit Life was a life insurance company during the years 1961-64 will be resolved in this proceeding by determining the percentage of life insurance reserves to total insurance reserves. If that percentage was greater than 50 percent, Georgia Credit Life was a life insurance company. If that percentage was not greater than 50 percent, Georgia Credit Life was not a life insurance company. Plaintiff's and defendant's alternative computations of the percentage of life reserves of Georgia Credit Life to its total reserves are attached as Exhibits 10 and 11. To the extent the computations conflict, they do not represent stipulated facts. A summary of the computations is as follows:

Plaintiff:

	1961	1962	1963	1964
Life Reserves	\$ 75,384.50	\$ 86,770.50	\$115,074.00	\$151,898.00
Non-Life Reserves	<u>74,216.00</u>	<u>81,276.00</u>	<u>113,597.00</u>	<u>141,938.00</u>
Total	\$149,600.50	\$168,046.50	\$228,671.00	\$293,836.00
% Life/Total Reserves	<u>50.39%</u>	<u>51.63%</u>	<u>50.32%</u>	<u>51.71%</u>

Defendant:

	1961	1962	1963	1964
Life Reserves	\$ 75,384.50	\$ 86,770.50	\$115,074.00	\$151,898.00
Non-Life Reserves	<u>114,352.83</u>	<u>195,741.64</u>	<u>306,789.40</u>	<u>390,926.98</u>
Total	\$189,737.33	\$282,512.44	\$421,863.40	\$542,824.98
% Life/Total Reserves	<u>39.731%</u>	<u>30.7139%</u>	<u>27.278%</u>	<u>27.983%</u>

SUBSTANTIVE FACTS

12. During the years 1961-64, plaintiff owned all of the outstanding stock of First of Georgia Insurance Company (hereinafter "Georgia Insurance"), and Georgia Insurance owned all the outstanding stock of Georgia Credit Life.

13. During the years 1961-64, the officers of Georgia Credit Life and of its parent, Georgia Insurance, were the same individuals. Georgia Insurance paid salaries to the employees of both companies and was reimbursed for the time of its officers devoted to Georgia Credit Life by a management fee charged Georgia Credit Life. The two corporations also shared the same offices.

14. Credit accident and health insurance is insurance on debtors with their creditors as beneficiaries and is used to pay debtors' monthly installments during the periods in which they are unable to work because of accident or sickness. Credit life insurance is term insurance on the lives of debtors with their creditors as benefi-

aries in amounts sufficient to discharge their indebtedness in case of death. When credit accident and health and life insurance coverage is provided in one contract the respective premiums are separately stated.

15. Credit accident and health and credit life insurance is sold in connection with a loan of money or an installment sale of tangible personal property. Its primary functions are to pay the debtor's monthly installments in the event the debtor is unable to work because of accident or sickness and to liquidate the balance due in the event of his death.

16. Credit accident and health and credit life insurance is written in two different ways: (1) under an individual insurance policy issued directly to the insured debtor, or (2) under a group policy, in which case the beneficiary-creditor is the policyholder and the individual insured debtor simply receives a certificate of insurance. It is generally written for a term which is coextensive with the contractual term of the related indebtedness.

17. Under a standard credit accident and credit health and life insurance policy, the creditor is the primary beneficiary to the extent of the monthly payment in the case of accident or sickness and the unpaid balance of the indebtedness account in the event of death. If the monthly insurance benefit exceeds the monthly installment because of prepayment of the loan, the excess is paid to the debtor. If the amount of the death benefit payable under the policy should happen to exceed the balance due on the account in event of death, the insured's designated secondary beneficiary or his estate receives the excess.

18. Benefits under credit insurance policies are computed differently, according to the type of protection afforded. Monthly accident and health insurance payments are determined by multiplying the number of days of disability times $1/30$ th of the monthly installment payment. Thus, if a debtor is disabled the entire month, the insurance pays the full month's installment.

19. A flat rate for credit accident and health and credit life coverage is charged, and generally no inquiry

is made as to the age, health or medical history of the applicant, except that there may be a maximum age beyond which coverage will not be available. The premium on a credit accident and health policy and the premium on a credit life policy are paid in one lump sum when a loan is obtained.

20. According to standard insurance accounting practices, when a credit accident and health premium under a single premium policy is paid by the insured at the time the loan is obtained, it is wholly "unearned" in the sense that the entire premium is attributable to the unexpired term of the policy. As the term of the policy expires with the passage of time, a proportionate part of the premium becomes "earned," i.e., attributable to insurance protection provided during the expired portion of the policy.

21. The allocable amount of accident and health insurance premium remaining unearned on a given date is usually computed on either a pro-rata basis or under the "sum-of-the-digits" method, the latter method being referred to in the insurance industry as the "Rule of 78." For example, if \$240 is paid for a two-year (24 month) policy, \$240 is unearned on the date the policy begins. After 12 months, the unearned premium computed on a pro-rata basis amounts to $12/24 \times \$240 = \120 . Under accepted insurance industry practice, a reserve equal to the amount of unearned premiums must be maintained by the insurer and listed as a liability on the books of the insurer. In the example the insurer must show a reserve liability of \$240 on its books for the unearned premium at the time the policy is written and a reserve liability of \$120 after 12 months. Computed under the Rule of 78, the unearned premium after 12 months

would be $\frac{12 + 11 \dots + 1}{24 + 23 \dots + 1} \times 240 = \frac{78}{300} \times \$240 = \$62.40$.

Thus, the unearned premium reserve liability would be \$62.40 after 12 months, if computed under the Rule of 78. The unearned premium reserves liability on the accident and health insurance in suit was determined under the "Rule of 78s."

22. The method of computing Georgia Credit Life's life insurance reserve liability is not in dispute.

23. On December 31, 1961, Georgia Credit Life and Georgia Insurance executed an agreement labelled Agreement of Reinsurance No. 1, a copy of which together with Exhibit A thereto is attached hereto as Exhibit 12. On December 12, 1962, the two parties executed Endorsement No. 1 to said agreement, a copy of which is attached hereto as part of Exhibit 12.

24. The aforesaid agreement was applied insofar as maintaining unearned premium reserves on accident and health policies is concerned as follows: Upon the issuance of an accident and health insurance policy, Georgia Credit Life set up an unearned premium reserve liability on its books of 100% of the total unearned premium from which a contra account (Reinsurance Premiums Ceded) representing 60% (70% after December 31, 1962) of the premium ceded was deducted and Georgia Insurance set up an unearned premium reserve liability of 60% of the total unearned premium (70% after December 31, 1962).

25. Pursuant to Article V of the agreement, Georgia Credit Life prepared quarterly reports containing the information specified in that Article and also the amount of commissions due Georgia Credit Life under Section 5 of Exhibit A of the Agreement. Copies to the reports for three quarters are attached hereto as collective Exhibit 13.

26. For the years ending December 31, 1961 through December 31, 1964, Georgia Credit Life and Georgia Insurance prepared annual reports on forms approved by the National Association of Georgia Insurance Depart-

ment. Copies thereof are attached hereto as Exhibit
14-21.

/s/ James R. Harper
Attorney for Plaintiff

R. JACKSON B. SMITH
United States Attorney

By: /s/ Fred Luyties
FRED LUYTIES
Attorney, Tax Division
Department of Justice
Washington, D. C. 20530

[Number and Title Omitted]

[Filed: February 19, 1973]

PRE-TRIAL ORDER

By direction of Honorable Anthony A. Alaimo, in an Order of Court dated December 21, 1972, the following facts, arguments, contentions and authorities are submitted for consideration of the Court for inclusion in a final pre-trial order.

1.

JURISDICTION OF COURT

This action arises under the Internal Revenue laws of the United States and is within the jurisdiction of this Court by authority of Title 28, Section 1346(a)1 of the United States Code. There is no issue as to the jurisdiction.

VENUE OF COURT

The plaintiff maintains its principal offices at 699 Broad Street, Augusta, Georgia, and these offices are within the geographical boundaries for venue for this division of Court by authority of Title 28, Section 1402 of the United States Code. There is no issue as to venue.

2.

MOTIONS PENDING OR PREVIOUSLY ACTED UPON

None.

3.

DISCOVERY

There is no additional discovery desired by either party in advance of trial.

4.

NAMES OF PARTIES

The above caption is complete and correct and there is no question of joinder or misjoinder.

OUTLINE OF PLAINTIFF'S CASE

During the years 1961 through 1964, First Railroad & Banking Company, the plaintiff herein, owned all of the outstanding stock of First of Georgia Insurance Company. First of Georgia Insurance Company owned all of the outstanding capital stock of First of Georgia Life Insurance Company (formerly First of Georgia Credit Life Company.)

The initial business of Georgia Life was that of a reinsurer. During the years 1961 to 1964, it was engaged both as a reinsurer and as a primary insurer writing credit life insurance and credit accident and health insurance. Under terms of an reinsurance treaty between First of Georgia Life Insurance Company and First of Georgia Insurance Company, First of Georgia Insurance Company acted as a quota reinsurer of 70% of all of its industrial or small loan health and accident insurance policies which were written by First of Georgia Life Insurance Company as primary insurer.

The plaintiff, First Railroad & Banking Company of Georgia, filed a consolidated return for each of the years 1961 through 1964 inclusive including the income of all of its subsidiaries except First of Georgia Life Insurance Company. First of Georgia Life Insurance Company filed a separate return. The plaintiff contends that First of Georgia Life Insurance Company was at all times a life insurance company within the definition of life insurance companies as found in Section 801(a) of the Internal Revenue Code of 1954. The privilege of filing consolidated returns under Section 1501 of the Internal Revenue Code does not extend to consolidation of life insurance companies within the meaning of Section 801 (a) because Section 1504(b) defines the term "includible corporation" as any incorporation except such insurance companies.

Each and every life insurance company, as defined in Section 801(a) must file a separate return, its results may not be consolidated with those of a parent, and the

plaintiff contends that a separate return was properly filed for First of Georgia Life Insurance Company. The defendant contends, and has determined, that First of Georgia Life Insurance Company income and expense (after the elimination of certain life insurance company tax benefits) should have been included as an element of plaintiff's consolidated return. There is no issue between the parties as to the computation of First of Georgia Life Insurance Company income. Certain tax advantages accrue to Section 801 insurance companies and the separate return of First of Georgia Life Insurance Company properly claimed those benefits. There is no issue as to computations either on the separate return as filed or upon the consolidated return as recomputed by the defendant. The sole issue for determination arises from the definition of life insurance company. If the life insurance reserves of First of Georgia Life Insurance Company were more than 50% of the total reserves of that company, then that company is a life insurance company and its results of operation may not be consolidated with those of its grandparent, the plaintiff herein.

If the reinsurance of accident and health insurance by that corporation is recognized then the Court must decide this proceeding for the plaintiff. The Court will be concerned in this proceeding with the bona fides of reinsurance. The reinsurance in question was under terms comparable to, and patterned after, reinsurance rates and terms that are usual in the industry between companies dealing at arms length with no inter-company stock holdings. The reinsurance in question was based upon sound practices and business purposes such as the need to expand the business of this newly formed company and other reasons related one way or another to the limited capital and surplus position of the credit life company. By the reinsurance in issue, accident and health insurance risks were in fact underwritten by First of Georgia Insurance Company which had excess surplus to guarantee insurance losses on accident and health policyholders. A safety factor from the subject reinsurance was the obvious result, because it reduced the ratio of net written

premiums to policy holder surplus. As a result of this reduced ratio accomplished by reinsurance, the life insurance company had a satisfactory financial statement in spite of limited capital and was able to expand its insurance coverage—both credit life and credit accident and health. The reinsurance treaty for credit accident and health insurance was absolutely binding on the reinsurer and total premiums on 70% of the Small Loan or Industrial Loan accident and health was currently ceded to the reinsuring company. At least partly as a result of the subject reinsurance, the sales of both credit life and credit accident and health insurance, was vastly expanded each year.

Reinsurance in the industry is so firmly established and generally regarded as so absolutely necessary that there can only be a question of whether the reinsurance terms and conditions were comparable to the industry generally.

The reinsurance here under scrutiny will clearly be shown to have been made under terms and conditions that were quite usual in the industry generally. The liability on unearned premiums on all reinsured policies should be, and could be, reflected only on the books of the reinsurance company—Georgia Insurance Company.

THE LAW

A. *Applicable Statutes*—All references are to the Internal Revenue Code of 1954.

SECTION 801. DEFINITION OF LIFE INSURANCE COMPANY.

(a) LIFE INSURANCE COMPANY DEFINED.

—For purposes of this subtitle, the term “life insurance company” means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

- (1) its life insurance reserves (as defined in subsection (b)), plus
- (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) LIFE INSURANCE RESERVES DEFINED.—

(1) IN GENERAL.—For purposes of this part, the term “life insurance reserves” means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * * *

(c) TOTAL RESERVES DEFINED.—For purposes of subsection (a), the term “total reserves” means—

- (1) life insurance reserves,
- (2) unearned premiums, and unpaid losses whether or not ascertained, not included in life insurance reserves, and
- (3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency serves (within the meaning of subsection (b) (4)).

* * *

SECTION 802(b) LIFE INSURANCE COMPANY TAXABLE INCOME DEFINED.—For purposes of this part, the term "life insurance company taxable income" means the sum of—

- (1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),
- (2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus
- (3) the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815.

* * *

SECTION 1501. PRIVILEGE TO FILE CONSOLIDATED RETURNS.

An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return.

* * *

SECTION 1504. DEFINITIONS.

* * *

(b) DEFINITION OF "INCLUDIBLE CORPORATION".—As used in this chapter, the term "includible corporation" means any corporation except—

* * * *

(2) Insurance companies subject to taxation under section 802 or 821.

* * * *

B. Case Law and Rulings

There is no case specifically in point on the proposition here before the Court, but the following cases may be helpful.

Alinco Life Insurance Company v. United States (US Ct of Cl 1967) 373 F.2d 336. In this case the Court of Claims approved life insurance status for a reinsurer who assumed and shares risks with the primary insurer. The business purpose of reinsurance was fully recognized by the Court.

The Court also recognized and approved the idea that the decision to reinsure need not invariably be based on actuarial need. The real question at issue was the proof of sound business purposes. Even tax considerations were recognized as an important element of sound purpose.

In the *Economy Finance Corporation, Transferee v. United States* (DC SD Ind.—July 25, 1972) case the Court held that reinsurance companies were not required to carry any of the accident and health insurance reserves because the primary insurance company was holding premiums under its treaty and the primary insurance company was not required to pay over the amounts of unearned premiums on a current basis. In short, only the earned premium was transferred at the end of the month to the reinsurance company. Thus the court held that the unearned premium reserves follows the premium in a valid reinsurance agreement. In the case here before the Court, by treaty and in actual practice, premiums included in the quota share ceded were currently transferred as written to Georgia Insurance Company who reinsured the losses.

Following the *Economy* case doctrine, the court here will find that the "unearned premium reserves" on ceded insurance follows the premiums and thus was properly reflected on the Georgia Insurance Company statements.

In *Superior Life Insurance Company v. United States* (CA 4—1972) 29 AFTR 2d 72-1370, the plaintiff, Superior Life, was a qualified insurance company selling credit life and credit health and accident insurance to the customers of its parent, Stephenson Finance Company. The finance company, who was not a qualified insurance company, acted as an agent for its subsidiary. The finance company collected the premium over to the insurance company only on a monthly basis as earned. The Court of Appeals, overruling the District Court, held that possession of the unearned premium by the parent was deemed to be possession by the insurance company. The funds in the finance company, parent's hands, were, the Court noted, in reality subject to the Superior Life Insurance Company's insurance obligations. To provide by agreement that a non-insurance company was entitled to hold the premium was found a sham.

In the instant case, the Court is considering two qualified insurance companies. By treaty, the quota share of premiums written had to be and was paid over currently to the reinsurance company who accounted for losses and current earnings.

6.

OUTLINE OF DEFENDANT'S CASE:

(a) Statement.

During the years 1961 through 1964, First Railroad & Banking Company, plaintiff herein, owned all of the outstanding stock of First of Georgia Insurance Company (hereinafter "Georgia Insurance"). Georgia Insurance owned all of the outstanding capital stock of First of Georgia Life Insurance Company (formerly First of Georgia Credit Life Company) (hereinafter "Georgia Credit Life").

Plaintiff filed Consolidated Federal Corporate Income Tax Returns with its corporate subsidiaries, except for Georgia Credit Life, for the years in suit. Georgia Credit Life filed Forms 1120 L, U. S. Life Insurance Company Income Tax Returns, for those years. The combined tax on such returns for each year was less than it would have been had Georgia Credit Life's income been included in the consolidated return as if it were a non-life insurance corporation.

The basis of this lawsuit is an "Agreement of Reinsurance" entered into by Georgia Insurance, the parent corporation, and Georgia Credit Life, its wholly owned subsidiary. On the basis of this agreement Georgia Credit Life, which was a primary writer of credit accident and health insurance, eliminated a substantial portion of its unearned premium reserves on accident and health insurance from its books. As a result of the reduction in accident and health reserves, the ratio of life insurance reserves to total insurance reserves (including both life and accident and health) on the corporate records of Georgia Credit Life during the years in suit remained slightly above 50 percent.

Taken at face value, Georgia Credit Life's reserves ratio qualified it each year as a life insurance company, because a life insurance reserves ratio in excess of 50 percent satisfies the test of a life insurance company under Section 801(a), 1954 Code.

Georgia Credit Life's computation of the aforesaid reserves ratio, however, was incorrect. The reserves ratio for each year was less than 40 percent because the reserves maintained by Georgia Insurance on the policies it purportedly reinsured should have been attributed to Georgia Credit Life. When those reserves (on accident and health insurance) are attributed to Georgia Credit Life, the following occurs: The total reserves of Georgia Credit Life are increased; and the ratio of life insurance reserves (the numerator) to total reserves (the denominator) decreases to 39.731%, 30.139%, 27.2787% and 27.983% for the years 1961-1964 respectively.

The insurance reserves maintained by Georgia Insurance should have been attributed to Georgia Credit Life

because the risk of loss on the insurance reinsured with Georgia Insurance was not shifted to Georgia Insurance. Georgia Credit Life instead remained on the risk for the accident and health insurance reinsured with Georgia Insurance. The risk of loss remained with Georgia Credit Life for the following reasons. First, losses on the reinsured business reduced Georgia Credit Life's revenues, not the profits of Georgia Insurance. Thus, the profits of Georgia Credit Life were directly dependent on losses on the reinsured policies. Second, Georgia Insurance's return was fixed at a constant four percent per the agreement. Thus, for every \$100 in premiums earned, Georgia Insurance received \$4 and Georgia Credit Life \$96 minus losses. It is true that Georgia Insurance would at least temporarily sustain a financial loss if the losses on \$100 of insurance exceeded \$100. In that event, Georgia Insurance would not collect its 4 percent (\$4) commission, and would reimburse Georgia Credit Life for claims it paid in excess of \$100; although Georgia Credit Life's commission based on \$96 minus the losses would be zero, it would be reimbursed for the claims paid in excess of \$100. In this manner, the agreement provided that the reinsurer could suffer a financial loss in certain situations.

For two reasons, however, the apparent risk to Georgia Insurance was so minimal that it still could not be said that Georgia Credit Life shifted the risk of loss on the reinsured accident and health insurance. First, the agreement also contained a carryover provision so that any reimbursements arising from the above determination would be recaptured in subsequent periods before Georgia Credit Life was paid a commission. Thus, any such excess loss would be ultimately borne by Georgia Credit Life in reduction of its revenues from the insurance written, although Georgia Insurance would temporarily sustain the loss.

Second, in the history of the agreement Georgia Credit Life's loss ratio never approached, much less exceeded, 96 percent of the premiums earned. In fact, the loss ratio remained at about 20 percent during the years in suit. Moreover, the two parties to the agreement could

not have reasonably feared a loss ratio as high as 96 percent because such a percentage is unheard of in the insurance industry, particularly credit insurance.

Rather than bona fide reinsurance, the agreement in question simply authorized the reallocation of certain bookkeeping figures—accident and health reserves—between the parent and subsidiary. This enabled both corporations to present a more favorable financial picture to outsiders; Georgia Insurance could point to a greater premium volume and Georgia Credit Life could relieve a drain on its capital surplus. Since surplus relief is not a legitimate basis for reinsurance, however, an agreement designed to further that end only without a shifting of the risk of loss (the *sine qua non* of reinsurance) is not a reinsurance agreement.

Consequently, the reserves on the reinsured policies should have been maintained by Georgia Credit Life. Since they were maintained by its corporate parent, they can and must be allocated to Georgia Credit Life in order to present the true condition and amount of its insurance reserves. As a result of this allocation, Georgia Credit Life does not qualify as a life insurance company under Section 801 (a) of the 1954 Code.

Since Georgia Life was not a qualified life insurance company and since it was a member of an affiliated group of corporations of which the plaintiffs was a common parent, Georgia Life's income should have been included in the consolidated returns filed by plaintiff and its other corporate subsidiaries during the years in suit. The Internal Revenue Service redetermined plaintiff's tax liability in the suit years by the above method and assessed the additional taxes sued for on the basis of that redetermination. Thus, plaintiff's additional tax plus interest were legally assessed and collected.

7.

PLAINTIFF'S OBJECTIONS TO DEFENDANT'S CONTENTIONS

The plaintiff objects to defendant's contentions as contrary to established precedent. Even if the defendant's

theory should be found to be soundly conceived, it would not support the legal conclusion that the reinsurance treaty should be disregarded. In the *Alinco Insurance Company* case, it was held that reinsurance could not be disregarded upon a theory such as the Government advances in this case. The Government could, at best, have undertaken an attack upon the corporation under Section 269 of the Internal Revenue Code.

The plaintiff further objects to defendant's contentions because these contentions seem to reflect absolute misunderstanding of the purpose of reinsurance. The argument that Georgia Insurance, the reinsurer, would not actually bear the risk of loss ignores the fact that it is the top risk which, even though unexpected, does in practice arise. It is this loss, if not reinsured, and if continued would put the company out of business by leaving it insolvent. Georgia Credit Life in fact did realize losses on credit accident and health insurance the first three years of this case. The loss payments did not exceed total premium in any year before the court, but the company lost \$22,050.00; \$24,973.00; and \$33,535.00 on accident and health insurance in the years 1961, 1962, and 1963. It was not until 1964 that the company showed any income from its credit accident and health and in this year there was only a \$15,280.00 gain. Georgia Credit Life would not have been able to expand its coverage and actually in the long run has paid much higher taxes because of the cession the Government now complains of.

Losses to policyholders in fact did exceed 100% of the premium in the case of some individual agents representing the Georgia Credit Life. There are some insurance companies which went out of business because of bad experiences.

The Government contention further ignores the important fact that by this reinsurance agreement the greater surplus of Georgia Insurance was brought in for policyholder protection. The testimony will show that even the Department of Insurance for the State of Georgia recognized that the reinsurance company was an underwriter of all of the losses that might be in-

curred by Georgia Credit Life on that share of the business ceded.

The Government's arguments further are weakened by the recognition of the fact that the total unearned premium reserves is a reserve for future obligations. At the time when the insurance written by Georgia Credit Life agents is reported to the company, a provisional commission is deducted by the agent equal to 50% of the total premium. The entire unearned premium on the insurance sold is recorded when in fact at least 50% never was received by the insurer. For this reason, it is found in the recent cases that the reserve for future obligations follows the premium. Under the reinsurance treaty here under consideration, the reinsurance company had a current right to the premiums. This right and the obligations related to those premiums was recorded currently on the reinsurance company's books. The premium on 60% (later 70%) of all credit accident and health insurance placed thru industrial act loan and small loan companies were obligated by treaty to the reinsurance company.

The plaintiff further objects to the defendant's contentions because the Government attaches much significance to the fact that of the A & H premiums ceded by Georgia Credit Life to Georgia Insurance only 4% is retained by Georgia Insurance even though that company carries the liability for insurance reserves (unearned premiums).

This is not a fair analysis of the situation. Approximately 90% of the accident and health premiums are written by agents, usually finance companies, handling industrial act loans who are compensated on a retrospective basis with a participation of 87½% of earned premiums which covers commissions and losses. If the industrial A & H was not reinsured Georgia Credit Life could retain 12½% of premiums written by these retrospective agents. Under the reinsurance treaty Georgia Credit Life keeps 30% of the premiums but after payment of agents commissions and taking credit for reinsurance commissions is able to retain 9.7% of the premium. Consequently, it is giving up to the reinsurer only 2.8% of the premium dollar after commissions while

keeping for itself 9.7% which must provide for all other costs including overhead and a provision for profit. Georgia Insurance while assuming 70% of the premiums and risks retains, after payment of commissions, 4% of its portion of the premium dollar which is the equivalent of 2.8% of such sum. The Government in its analysis would have it appear that a ratio of 96% to 4% which is 24 to 1 is a significant factor to be considered. However, the proper relationship is the retention after payment of commissions and/or losses which would be 9.7% or 2.8% respectively or a ratio of slightly over 3 to 1.

In the insurance industry it is customary for commissions paid by the reinsurer to the primary insurer for premiums ceded to exceed the amount of commissions paid by the primary insurer to its agents on premiums written. Consequently, the provision for reinsurance commissions of 96% minus losses is not unusual or excessive in view of the fact that the writing agent, usually a finance company, was allowed compensation of 87½% minus losses. Thus, the primary insurer had a retention of 12½% with which to pay all other expenses, including underwriting expenses, maintenance of records, claims expenses and provide for nominal profit. The reinsurer received 4% of the business assumed or 2.8% of the premiums. Its overhead and expenses in relation to the business assumed were minimal. Therefore, a small or reasonable profit would ordinarily result except in case of unusual losses.

The Government, in its analysis of *Superior Life Insurance Company v. United States*, *supra*, has failed to note that Stephenson Finance Company was not a qualified insurance company and obviously could not have held the premium for that reason. The only insurance company involved was Superior Life Insurance Company, the subsidiary, and the finance company could not arbitrarily withhold transfer of the premium to the one responsible to the policyholder.

The Government has erroneously failed to reconcile *Economy Finance Corporation*, *supra*, and *Superior Life Insurance Company*, *supra*. In both cases the Court was

concerned with the right to the premium. Superior Life Company was the only qualified insurance company and, therefore, the only one entitled to the premium. In the *Economy Finance Company* case the reinsurance companies were United Public Life Insurance Company and National Public Life Insurance Company. Neither of these corporations were qualified as insurance companies, in Indiana. In the *Economy Finance Company* case the Government erroneously tried to allocate unearned premium reserves to these reinsurance companies who had no right under their treaty to the premiums except as earned. The Government could not have assigned unearned premium reserves to these non-qualified insurance companies, and the Court so recognized.

8.

DEFENDANT'S OBJECTIONS TO THE PLAINTIFF'S CONTENTIONS.

(a) That Georgia Insurance was, in fact, reinsuring accident and health policies written by Georgia Credit Life.

(b) That Georgia Credit Life was a life insurance company as defined by Internal Revenue Code, Section 801(a).

(c) That there was a business purpose behind the reinsurance agreement of Georgia Insurance and Georgia Credit Life.

(d) That Georgia Credit Life properly filed separate Federal Income Tax Returns or that it properly claimed tax benefits allowable to life insurance companies on those returns.

(e) That the Court must find for plaintiff if it finds that Georgia Insurance reinsured health and accident insurance written by Georgia Credit Life. Such a decision does not necessarily follow, since the ultimate factual question for the Court to decide is whether the reserves maintained by Georgia Insurance on the accident and health insurance written by Georgia Credit Life must be attributed to Georgia Credit Life.

(f) That the only question in regard to the existence of bona fide reinsurance was whether the reinsurance terms and conditions were comparable to those in the industry generally. The existence of other similar agreements does not mean that the agreement in question effectively shifted the risk of loss which it must have done to validate Georgia Credit Life's bookkeeping reduction of its non-life reserves.

9.

BURDEN OF PROOF

This is a non-jury trial and the parties request opening and closing arguments. The burden of proof is upon the plaintiff.

10.

PLAINTIFF'S WITNESSES

The following witnesses will be present at the trial:

Mr. Fleming M. Love, Jr.
Senior Vice President
First Railroad & Banking Company of Georgia
699 Broad Street
Augusta, Georgia 30903

Mr. Herb Parks
Peninsular Fire Insurance Company
645 Riverside Avenue
Jacksonville, Florida 32204

Mr. E. R. Phillips
2128 Central Avenue
Augusta, Georgia 30903

Mr. Lep Mothner
699 Broad Street
Augusta, Georgia 30903

Mr. A. C. Eddy
3167 Linden Road
Rocky River, Ohio 44116

DEFENDANT'S WITNESSES .

The following witnesses will be present at the trial:

Howard P. Fleischer
Field Audit Branch
Audit Division
Internal Revenue Service
Atlanta, Georgia

Robert A. Zelten
Department of Insurance
University of Pennsylvania
Philadelphia, Pennsylvania 19104

Bobby Clark
Box 2
Hopkins, S. Carolina 29061

11.

DOCUMENTS AND PHYSICAL EVIDENCE

(a) List of documents to be introduced by plaintiff

1. Letter dated June 26, 1961 from General Reinsurance Corporation, signed by Donald G. Parker, Vice President, quoting terms for credit accident and sickness reinsurance.

2. Reinsurance treaty between First of Georgia Insurance Company and First of Georgia Credit Life Company, dated December 31, 1961.

3. Computation of the ratio of life insurance reserves to total reserves of First of Georgia Life Insurance Company for each of the years 1961 through 1964, inclusive.

4. Statutory notice issued to First Railroad & Banking Company of Georgia for the years 1961 through 1964 inclusive.

5. Summary of losses. Defendant's objections to the above documents: None.

(b) List of documents to be introduced by defendant

1. Federal Corporate Income Tax Returns of plaintiff and of Georgia Credit Life for the year 1961 through 1964.

2. National Association of Insurance Commissioners (NAIC) Annual Statements of Georgia Insurance and Georgia Life Credit for the years 1961 through 1964.

3. Computation of the ratio of life insurance reserves to total reserves of Georgia Credit Life for the years 1961 through 1964.

4. Quarterly accounting reports containing the computation of commissions due Georgia Credit Life under the agreement between Georgia Insurance and Georgia Credit Life.

5. Reports of Examination of Georgia Credit Life and Georgia Insurance by the Georgia Insurance Department.*

6. Part B, Reinsurance Subcommittee Reports, of NAIC Examiners Handbook.

7. Summary of earned premiums compared with the losses during each of the years 1961 through 1964 inclusive.

8. Selected minutes of the Board of Directors for Georgia Life Insurance Company.

* Plaintiff's objection to the above documents: None, except as noted in the following paragraph as to 1969 Report of Examination.

12.

DEPOSITIONS TO BE OFFERED

(a) Plaintiff's witnesses

1. Lawrence W. Earls

(b) Defendant's witnesses

1. H. B. Sturtevant

Plaintiff's objection to defendant's deposition of H. B. Sturtevant.

The plaintiff objects to the deposition of H. B. Sturtevant and the report on the Association Examination of the First of Georgia Life Insurance Company as of De-

cember 31, 1969. This deposition has to do with an examination made of years after those before the Court. They have no relevancy to the present proceeding.

13.

MEMORANDUM OF AUTHORITIES

1. Plaintiff: Previously set out on page 5.
2. Defendant:

(a) Section 802(a) Internal Revenue Code of 1954, imposes an income tax on the taxable income of every life insurance company. Subsection (b) defines "Life Insurance Taxable Income". The net result is that life insurance companies pay less income tax than other insurance companies.

(b) Section 801(a) provides that an insurance company qualifies as a life insurance company if its life insurance reserves comprise more than 50% of its total reserves. "Total reserves" include not only life insurance reserves but also unearned premium reserves and all other reserves required by law. Section 801(c).

(c) Treasury Regulations on Income Tax, § 1.801-3(e):

Unearned premiums. The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

(d) Ga. Code Ann. § 56-413: Georgia Law provides for a deduction in insurance reserves where a company has reinsured a portion of its risks with another company. Thus, there must be an assumption of risk in Georgia to meet the test of bona fide reinsurance.

(e) Part B, Subcommittee Reports, of NAIC Examiners Handbook (a copy of which is attached hereto):

(1) Page B6 (Conclusions) :

The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer, not only in form but in fact, against loss or liability by reason of the original insurance. Unless the so-called reinsurance contract contains this essential element, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer.

(2) Page B23 (Conclusions) :

Non-risk-transferring reinsurances

1. The transfer of risk from the ceding company to the reinsurer is the essential element of every reinsurance contract.

2. Surplus aid contracts do not provide, except sometimes nominally, for the transfer of risk, even though the ceding company has taken credit in its financial statement for the cession of such risk.

3. American statutory and accounting standards require an unearned premium reserve to be established on a gross basis, pertaining to all net business at risk.

(3) Page B14 (Surplus Aid Contracts) : The *sine qua non* of a legitimate reinsurance transaction is the transfer of risks from the primary insurer to the reinsurer. Such risks are not transferred where, as in the case of surplus aid contracts, the primary insurer is not relieved of liability on the policies purportedly reinsured.

(4) Pages B14-16 (Guaranteed Profit Contracts) : A guaranteed profit contract is one form of surplus aid contract wherein the primary insurer's liability is not, in fact, transferred to the reinsurer under a reinsurance agreement. Its characteristics include: A set

fee of two to five percent to the reinsurer; a tentative commission to the primary insurer; and an additional commission to the primary insurer based on loss experience. The additional commission is reduced one dollar for each dollar of losses and thus is not paid if the losses equal or exceed the amount of additional commission. The tentative commission is allowed the primary insurer immediately but will be reduced one dollar for each dollar if losses exceed the additional commission. In that event, the tentative commission is returned to the reinsurer to offset the excess losses. The handbook notes there is a slight element of risk taking on the part of the reinsurer but that it is so remote that it is largely of academic interest. Therefore, the handbook states, "(T)he ceding company (i.e., primary insurer) still remains exposed to the same risk as before." Page B15, first paragraph.

The reinsurance agreement between Georgia Credit Life and Georgia Insurance was essentially a guaranteed profit contract without a tentative commission provision. This latter feature simply made the agreement on paper less favorable to the primary insurer (Georgia Credit Life). It did not relieve Georgia Credit Life of any liability or any risk of loss from such liability.

The handbook further provides that the reserves maintained by the primary insurer in the case of a guaranteed profit contract should be the full unearned premium reserve without any credit for the percentage allegedly reinsured. Page B16, third paragraph.

- (f) *Superior Life Insurance Co. v. United States*, 462 F. 2d 945 (C.A. 4, 1972): An insurance company cannot qualify as a life insurance company under the Section 801(a) reserves ratio test by artificially allocating non-life insurance reserves (other-

wise includible in the denominator in the above ratio) to its parent corporation.

Superior Life was not a reinsurance case. It is nevertheless significant because it required the attribution of unearned accident and health premium reserves held by a finance company to its wholly owned insurance company. This was done, despite contrary written agreement between the parties, in order to reflect the true nature of the insurance transactions. The agreement between Georgia Credit Life and Georgia Insurance is but another attempt to accomplish from one business entity to another for purposes of qualification under the reserves ratio test.

(g) *Alinco Life Insurance Co. v. United States*, 373 F. 2d 336 (Ct. Cl. 1967): The reinsurer of credit life insurance qualified as a life insurance company under Section 801(a) because all of its reserves were life reserves. The Government had argued that credit life insurance was not life insurance but actually property insurance and that the taxpayer was not even an insurance company. In rejecting the latter argument, the court noted that since the taxpayer assumed risks funded by reserves it was an insurance company. *Alinco, supra*, p. 350. Clearly the taxpayer did bear the risk of loss because it agreed to reimburse the primary writer for 18 percent of its losses on credit life insurance in return for 18 percent of the gross premiums on such insurance. *Alinco, supra*, p. 339. Thus, the primary writer was unconditionally relieved of the risk of loss on a fixed percentage of its business; the reinsurer did fully bear such risk because the losses paid directly reduced its profit from premiums received. Moreover, the reinsurer did not receive a guaranteed fee for its services.

Alinco recognized reinsurance as a legitimate method of shifting risks, allowing the reinsurer to maintain reserves to cover the risks. The Commissioner of Internal Revenue, however, also recognizes legitimate reinsurance. Treasury Regulations

§§ 1.801-3(a)(1) and 4(d). Since the present action involves the question of which company bore the risk of loss, not whether reinsurance is recognized under the Internal Revenue Code, *Alinco* does not support plaintiff's theory.

(h) *Local Finance Corp. v. Commissioner*, 407 F. 2d 629 (C.A. 7, 1969): This decision, cited by plaintiff in its Memorandum of Authorities, has no relevance to the question in this action. *Local Finance* involved the allocation of income arising from credit life business between finance companies, insurance brokers and a reinsurer. There was no issue as to qualifications of an insurance company as a life insurance company under the reserves ratio test of Section 801(a). The facts, however, indicate that bona fide reinsurance was involved, although, such was not crucial to the court's decision.

(i) *Economy Finance Corp. v. United States*, 72-2 U.S.T.C. (S.D. Ind., July 25, 1973): This case is contrary to *Superior Life*. It holds that a primary writer can enter into a reinsurance agreement whereby it will reinsure all of its credit life business but only a fraction of its credit non-life business, thus enabling the reinsurer to qualify as a life insurance company. Such qualification occurs because the life reserves maintained by the reinsurer greatly exceed its non-life reserves. The court held that the reinsurer was a life insurance company because there was no reinsurance of the accident and health insurance except for the amount of the previous month's earned premiums.

Here plaintiff argues that the primary insurer qualified as a life insurance company because there was reinsurance of accident and health. *Economy Finance* does not support plaintiff's argument because in that case the question was not whether risk of loss was transferred. The court found that the risk was assumed by the reinsurer only on a month-to-month basis—not at the time a policy was issued but each month as a portion of the premium was earned. Since premiums were paid the reinsurer

only on an earned premium basis, the court found that the reinsurer was not required or entitled to maintain any *unearned* premium reserve. *Economy Finance, supra*, pp. 85, 520-21.

In *Economy Finance*, moreover, the reinsurer bore the risk of loss—and thus reinsured the accident and health business to that extent—by directly reimbursing the primary writer for all losses during the preceding month. The reinsurer's profits were reduced *pro tanto* by losses on the reinsured business, whereas the primary writer's profits on such business were unaffected by losses.

Economy Finance does not apply to the facts of this case except to lend support to the Government's contention that the party who actually suffers the losses on the business is the one who bears the risk of loss (and, in turn, is the one who must be attributed with the corresponding reserve). To the extent that *Economy Finance* has approved a contrivance for the artificial allocation of life and non-life insurance reserves, however, the Government contends the decision is wrong and will not follow it.

(j) Section 831, Internal Revenue Code, provides for a tax substantially equivalent to that on ordinary corporations on the taxable income of insurance companies which are not life or mutual insurance companies. If Georgia Credit Life did not qualify as a life insurance company during the years in suit, it must therefore be taxed under Section 831.

(k) Conclusion: The ultimate question in the present action is whether the reserves maintained by Georgia Insurance on accident and health insurance written by Georgia Credit Life, its wholly-owned subsidiary, should be attributed to Georgia Credit Life for purposes of applying the reserves ratio test of Section 801(a). Defendant contends they should, as they were in *Superior Life Insurance Co., supra*.

By the nature of the reinsurance agreement, Georgia Insurance, the reinsurer, would not actually

bear the risk of loss. Instead, losses were to be deducted from Georgia Credit Life's commission, thus reducing its profit, while the income of Georgia Insurance would remain constant at four percent, Georgia Credit Life in reality paying the claims and bearing the risks associated therewith. Georgia Insurance's profit would be reduced only in the unlikely event that the loss ratio exceeded 96% of earned premiums. Since even then the profit deficit would be made up in subsequent periods, Georgia Credit Life ultimately bore the risk of loss on all reinsured policies.

It is axiomatic in the insurance industry that reserves must follow the true risk. NAIC Examiners Handbook, *supra*; cf. Tr. Reg. Section 1.801-4(a); Rev. Rul. 69-7, 1969-1 Cum. Bull. 186. Since Georgia Credit Life bore the risk of loss, the reserves on the accident and health insurance reinsured with its corporate parent must be attributed to it. In that case, Georgia Credit Life does not qualify as a life insurance company under Section 801(a) because its ratio of life insurance reserves to total reserves is less than 50 percent.

14.

JURY CHARGES

Not applicable. This is a non-jury trial.

15.

TRIAL TIME

Plaintiff's counsel estimates one day to present the plaintiff's case; defendant's counsel estimates one day to present the defense. These estimates presume a five hour trial day.

16.

OFFER OF SETTLEMENT

There has been no offer of settlement by the defendant. The attorneys have conferred with the Court as to the matter of settlement.

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17.

RULINGS DESIRED PRIOR TO TRIAL

None.

18.

IT IS HEREBY ORDERED that the foregoing constitute a PRE-TRIAL ORDER in the above case and that it supersedes the pleadings which are hereby amended to conform hereto and that this PRE-TRIAL ORDER shall not be amended except by consent or by ORDER OF THE COURT, to prevent manifest injustice.

This 19 day of February, 1973.

/s/ Anthony A. Alaimo
District Judge
Approved as to form and substance:

/s/ James R. Harper
Attorney for Plaintiff

R. JACKSON B. SMITH, JR.
United States Attorney

By /s/ Fred Luyties
FRED LUYTIES
Attorney, Tax Division
Department of Justice
Washington, D. C. 20530

[1]

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF GEORGIA
AUGUSTA DIVISION

Civil Action Number 1738

FIRST RAILROAD AND BANKING COMPANY OF GEORGIA,
PLAINTIFF

versus

UNITED STATES OF AMERICA, DEFENDANT

Transcript of proceedings in above case in the United
States District Court before The Honorable
Anthony A. Alaimo on February 19, 1973

APPEARANCES FOR THE PLAINTIFF:

JAMES R. HARPER
1526 Fulton Nat'l Bank Bldg.
Atlanta, Georgia 30303

APPEARANCES FOR THE DEFENDANT:

FREDERICK LUYTIES
Tax Division
Department of Justice
Washington, D. C.

EDMUND BOOTH
Asst. U. S. District Attorney
Federal Post Office Bldg.
Augusta, Georgia 30902

[2] MR. E. RUSSELL PHILLIPS took the stand, and having been duly sworn, testified as follows:

DIRECT EXAMINATION OF MR. PHILLIPS

BY MR. HARPER:

Q. Would you state your full name and address, please

A. E. Russell Phillips, 2128 Central Avenue, Augusta, Georgia.

Q. Were you ever connected with the company, that we have used for shorthand here, Georgia Insurance Company?

A. Yes sir, I run it.

Q. What was the first name of that business?

A. First of Georgia Fire and Casualty Company.

Q. What was the nature of its business?

A. The writing of fire and casualty insurance.

Q. When did that company begin operations?

A. July 1, 1956.

Q. When did you go to work for that company?

A. The same date.

Q. What was your connection with that company?

A. At July 1, 1956 the position of comptroller.

Q. Did you have any experience in accounting at that time, any special training and education?

A. Yes, I did.

Q. Will you explain what that experience and education was?

A. I had education at the college level and then experience [3] with a local CPA firm.

Q. You had actually been engaged in the practice of public accounting?

A. Yes.

Q. You went to work really as what might be described as a chief fiscal officer?

A. Yes, sir.

Q. From 1956 until about 1958, what was the experience of that company financially?

A. Very good and very sound.

Q. Was there—what was the reserve—what was the surplus position of that company, in accumulated earnings, for example?

A. The surplus position of the First of Georgia Fire and Casualty through that period was very sound—very substantial. It was initially capitalized at a substantial amount, and had retained substantial surplus in capital.

Q. What was your connection with First of Georgia Insurance in 1958?

A. The dates escape me, as far as the positions I held as they turned, but I progressed from 1956 through the positions of comptroller, secretary, treasurer, vice president, holding one of those offices and at some times a combination of the two, up to a period of August, 1966.

Q. Did First of Georgia Insurance Company have occasion to form any subsidiary companies during that time of your [4] tenure?

A. It did.

Q. What companies were formed?

A. First of Georgia Credit Life Company.

Q. What was the nature—what was the purpose of that formation?

A. The purpose initially was the writing of credit life insurance.

THE COURT: When did it form it?

A. In 1958, sir.

Q. Did the company in fact go into credit life insurance. . .

A. It did.

Q. . . . and when?

A. It did.

THE COURT: Which one?

A. First of Georgia Credit Life Company.

Q. Could the Casualty Company, the parent, have gone into life insurance?

A. Under the state—under the laws of the State of Georgia, no.

Q. Georgia Credit Life Company then went into the business of selling credit life, and in what capacity did it sell credit life?

A. At the outset primarily as a reinsurer.

Q. For what company?

A. For Piedmont Southern Life Insurance Company.

[5] Q. And who were the agents for that?

A. Georgia Railroad Bank & Trust Company.

Q. Did the nature of the business change in the first years of operation?

A. It did.

Q. Would you describe that change?

A. During the first years of operation—at that time First of Georgia Fire and Casualty Company—a substantial amount of business was being produced in the casualty field by an agency force, represented by small loan companies, finance companies. The desire of these agents was to produce all of their insurance in a package—one company, if possible. The laws of the state prevented us the inclusion of life or accident, well of life, in a casualty company, so First of Georgia Credit Life was formed to complete the package, so to speak, of business available to us from these sources.

Q. Was a decision made to expand the business from purely credit life to accident and health insurance?

A. Yes, it was.

Q. What was the basis of that decision?

A. The necessity of our agents—the necessity of providing accident and health coverage to our agency force.

Q. In your capacity as an officer of First of Georgia—I didn't ask you that—but did Georgia Credit Life make [6] you an officer, or something?

A. Yes.

Q. What were your responsibilities with the Credit Life Company?

A. My official title, capacity, and responsibilities were essentially the same as in the Casualty Company, or Insurance Company under a later name change.

Q. As the Accident and Health Insurance Company sales increased, what business considerations did you have in mind? What problems were encountered?

A. We considered problems such as these. With the expanding business, the rapid growth of the business that we anticipated, we felt a definite need for reinsurance, through this period of expansion at least.

Q. What steps did you take in order to evaluate the possibilities of entering into a reinsurance agreement for accident and health insurance?

A. We investigated—and when I say we, the management officials of First of Georgia Credit Life—we investigated sources of insurance and methods of insurance—sources of reinsurance and methods of reinsurance available to us at that time, with the idea of arriving at some form of reinsurance that we felt would provide us with the purposes we had grafted.

Q. I would like to identify a letter of General Reinsurance Company to Mr. E. R. Phillips, June 16, 1961. Did you obtain quotations from a number of outside companies who might [7] place this reinsurance?

A. We did.

Q. Did you consider any particular company's bid? And I hand you here a document that's been identified as Plaintiff's Exhibit 22.

A. We did. We gave consideration to a bid in response to our request from General Reinsurance Corporation, New York City.

Q. Would you say that that bid was characteristic of other bids that you received at that time?

A. Yes.

Q. Did you have occasion to decide whether to accept or reject that bid of General Reinsurance Company?

A. Yes.

Q. Would you explain what the basis of your decision—what the decision was, and what was the basis for it?

THE COURT: Mr. Harper, for my assistance, when you refer to "they", please specify the company you are talking about.

MR. HARPER: Georgia Credit Life Company.

THE COURT: Good.

Q. What—

A. The management decision was made to adopt the reinsurance agreement basically in line with that quoted to us by General Reinsurance Corporation. The decision was also made to contract with the parent com-

pany, First of Georgia [8] Insurance Company, rather than to go outside for certain mutual advantages.

Q. Why did you make that decision on the part of Credit Life Company to deal with the parent in this reinsurance?

A. There were mutual advantages to both companies.

THE COURT: What were they?

A. The advantages, as I recall, feel existed at the time—to the Life there existed—it gave the Life Company a basic spread of risk through a quota share of reinsurance, that is a transfer of risk, each and every individual risk.

THE COURT: Why was that any better with its parent than it would have been with the General Reinsurance Company?

A. From the standpoint of the Credit Life Company, probably none. It would have been the same in either case.

THE COURT: All right.

A. But it gave us this spread of risk which we felt would enlarge our base on which we could write and produce business which we felt was—would be coming to us in rather large volume over a rather short period of time. Another factor, of course, is—obviously is a tax consideration, as was our custom in most business transactions to—we thought it prudent to determine the tax effect. Then further, it gave us a much better ratio—it allowed us a much better ratio of net written premiums to our capital structure. We [9] felt that there was. . .

Q. Where does that net written premiums capital structure come in?. Why is that important? Does that have anything to do with the expansion of business?

A. Well we felt it was important for this reason—yes. We felt that there was—we felt that we would reach a limit with an influx of volume of business. We felt that there was a limit as to the net written premiums that we could handle with the capital structure that we had in relation to the capital structure.

Q. Isn't that in fact a restriction that is recognized by the State of Georgia and was at that time by the Insurance Commission?

A. A relationship. . .

Q. Did they find that a ratio of net written premiums to capital structure a limiting factor in the expanding business?

A. They considered it a prudent move, yes, to keep a—to keep a relationship between the net written premium and your capital structure.

Q. The lower the ratio the better?

A. Generally speaking, yes. Another—another business advantage that we felt accrued to the Life Company was that the capital—we had capitalized the Credit Life Company at the minimum capital structure, as I recall, permitted by the State of Georgia. Reserves, capital, the capital and surplus and [10] reserves are required to be funded, and we felt that reinsurance eased the requirements of funding the reserves in the Life Company.

THE COURT: How does it?

A. Your Honor, the laws at that time required that the capital structure of Life Insurance Company, plus its reserves, that assets must be maintained, and these assets are regulated to a degree, the capital assets in a, what you would consider a more liquid form, more convertible to liquid, to the extent of the capital structure of the company. Then further, the reserves must be funded by assets, and with a little broader—a little more range of the type of investments you could make to cover those.

THE COURT: I don't understand it. I still don't understand it.

A. Well, a large capital structure, of course, if I may give an illustration, the larger the capital structure the larger the number of investments in a more limited form, such as cash, U. S. bonds, real estate mortgages.

THE COURT: All right.

A. Then beyond the capital structure the reserves must all—the investments must also be maintained to cover the reserves. However, there is more freedom of

activity in the type of investments with—from the reserve structure, common stocks, things of that sort can be brought in then.

[11] THE COURT: All right. Now this reinsurance contract, or the provisions that you had, would have been equally beneficial to Credit, Georgia Credit, whether it was by this General Reinsurance or XYZ Company for your parent company. . .

A. I feel that it. . .

THE COURT: . . . its benefits would have been the same, would it not?

A. The benefits to the Credit Life Company, I feel, would have been the same.

THE COURT: All right.

Q. Were there any benefits or reasons which would have justified the agreement from the standpoint of the parent company, Georgia Insurance?

A. Yes, there were. The First of Georgia Insurance Company, with—under a good loss experience to the First of Georgia Insurance Company, they would realize earnings—they would realize maximum earnings on the reinsurance assumed to the extent of 4% of those earned premiums. In addition, it created a cash flow towards the insurance company which would result over a period of time in increased investment income to them.

Q. Did it have any effect on business written, as that is reported in the standard publications of Best?

A. Yes, from the standpoint of the Insurance Company, Alfred M. [12] Best Company, they have publications which we considered at that time—and I think the industry generally considers the Dun & Bradstreet—all companies are concerned with their statement as it appears in Alfred M. Best. This permitted the Insurance Company to show a greater premium production volume, which was an enhancement to First of Georgia Insurance Company at that time. We were interested in doing this.

Q. When we went to the stand, I handed you an exhibit stipulated as Exhibit 12, which is in fact the reinsurance agreement, as amended.

A. Yes.

Q. I ask you to refer to that and tell the Court whether that is one which is comparable to those in the industry. . .

A. Yes.

Q. . . . between companies at arm's length?

A. Yes, it is.

Q. Would you explain the elements of that? Did you take an active part in drafting that reinsurance agreement?

A. Yes, I did.

Q. Did you use the General Reinsurance Company letters or quotation as a basis for the actual commissions involved?

A. Yes, I did.

Q. Under that agreement, what percent of the commission was to be retained by the reinsurer, Georgia Insurance Company?

[13] What percent of the total premium was to be retained?

A. What percent of the total premium was to be retained by First of Georgia Insurance Company? Mr. Harper, are you speaking of the session or of the premium, or of the income evolving from it?

Q. Well, you may answer all of them.

A. Right. Well, basically, if I may take this agreement—if I deviate from the question, please correct me—but basically the agreement provides for a cession of insurance premiums from First of Georgia—from Georgia Life—to the assuming insurer, Georgia Insurance, to the . . .

Q. When is that ceded?

A. To the—when is it ceded?

Q. Yes.

A. It is ceded as it is written.

Q. And on an as-written basis?

A. On an as-written basis.

Q. All right, go through it.

A. In a quota share participation, as stipulated by the contract, 60% and later 70%, which results in the session of premiums on an as-written basis to that extent from Georgia Life to Georgia Insurance. The losses

—the loss recoveries under the reinsurance agreement follow the premium. Losses are participated in on a reinsured basis on the same basis as the premiums.

[14] THE COURT: 70/30?

A. 70/30, yes sir. Georgia Insurance assumed 70% of the premiums of this class of business, the class of business that we considered produced by industrial loan agents writing for us. They assumed 70% of the premiums from Georgia Life. They also assumed and paid 70% of all losses payable thereunder. Then on a quarterly basis—there was no provisional or tentative or guaranteed commission, whichever term you might use, involved in the contract.

Q. What do you mean by that? I am not sure I understand what a provisional or tentative commission is.

A. Well, provisional, tentative or guaranteed commission which is—as—we will say that—I would—my term would be as usual in the business in a reinsurance contract.

Q. Well, isn't that one of the gimmicks of the business that, a provisional—in other words, you cede a quota of the insurance over to the reinsuring company, and he right away gives you something back before it's earned?

A. Yes, sir.

Q. Isn't that what you mean by. . .

A. There was no immediate commission involved.

Q. You didn't have. . .

A. Commission. . .

Q. . . . the provisional ceding from Georgia Insurance. They got 70% and retained the 70% and Georgia Life realized [15] something only on an as-earned basis?

A. This is correct.

Q. There was no provisional ceding back on an estimate now. Provisional in this sense is comparable to the discussion I had with the agents, Your Honor. He takes the half of it right away, but these people realize nothing on that 70% except as time passed.

THE COURT: Well, now, at that time the 50% that he turns over, then is 70% of that turned over by credit to First of Georgia?

A. No, sir, the 50%. . .

THE COURT: The full amount?

A. Well, may I state this? The 50% that Mr. Harper has referred to is an agency commission.

THE COURT: Yes, sir.

A. The agent is not involved in this contract in any manner.

THE COURT: I understand that, but he keeps 50% of it, doesn't he?

A. The agent, yes.

THE COURT: Yes. All right. The other half goes to Georgia Credit. Georgia Credit turns it over to Georgia Life—I mean First of Georgia?

A. 70%.

THE COURT: 70% of that 50%?

[16] A. No, sir. 70% of the original 100.

THE COURT: Well, for example, if the premium was \$100.00, the agent would give Georgia Life \$50.00, Georgia Life would give First of Georgia \$70.00?

A. Yes, sir.

THE COURT: Is that it?

A. Yes, sir.

THE COURT: Okay.

Q. Now, the term "give them \$70.00", actually, part of this is accrual accounting, is it not?

A. Yes, it is.

Q. According to receivables and. . .

A. Yes. Then on an earned basis, only after the premiums are earned, the contract calls for—I believe it calls for quarterly determination of the reinsurance commission due to Georgia Life under the terms of the contract. The contract effectively permits Georgia Insurance 100% of the earnings on the business they had assumed, reduced by their participation in the losses that had been paid, further reduced by the commission to Georgia Life, the balance being the net retention, the earnings on the net retention to Georgia Insurance.

THE COURT: Well, give me a simple illustration using \$100.00.

A. If the contract calls for a sliding scale commission to Georgia Life; that is as the loss experience goes up, the commission [17] comes down. . .

THE COURT: Right.

A. . . . on a dollar for dollar basis. So that Georgia Insurance, their maximum earnings on the business that they reinsured, was fixed at 4% maximum that they might earn, under optimum. . .

THE COURT: But they had them under. . .

A. Beg your pardon, sir?

THE COURT: Well, that was their maximum. If there were earnings, they got theirs first?

A. Yes, sir.

THE COURT: All right.

A. Well, first in this sense really. If the loss ratio was good—if the loss ratio was under 96%, then it became immaterial. Above, now if the loss ratio went about 96%, no, Georgia Insurance did not get their earnings first.

THE COURT: I understand.

Q. This is by the treaty they did not get them?

A. By this treaty agreement.

Q. Actually they did not get them.

THE COURT: Yes. All right.

A. Then, so under the terms of this commission contract, earned premiums for the quarter on the business assumed by Georgia Insurance—take the \$100.00 as a base—we would take 96% of that, because that's the amount—in other words, that [18] amount Georgia Insurance cannot earn, under the terms of the agreement. So we take 96% of that, which would be \$96.00. Assume there are \$50.00 in losses. Deduct the \$50.00—deduct the \$50.00 from the \$96.00 would leave \$46.00, that would be the reinsurance commission payable to Georgia Life.

Q. Would you—would you tell the Court what the maximum is that could have been realized, the difference between these two commissions. We have spoken now of a commission which would be an expense, and that's the amount paid to the agent. How was that finally computed?

A. The commission to the agent?

Q. Right.

A. The commission to the agent in most instances in this line of business—we had what was termed a retrospective commission basis. And in most instances it was on an 87½% basis, which would mean that the agent was allowed 87½% of the premiums he produced out of which to pay losses and his commission, so that again in a similar manner the commissions of agents was on a sliding scale basis. On a quarterly basis we would determine the earned premium within a given agency. That would result in a credit to the agent. Then against that figure would be charged the actual losses incurred in that quarter.

Q. Who actually paid the losses?

[19] A. First of Georgia Life. Against that would be charged the actual losses incurred and the difference was the ultimate commission to the agent. Now he was allowed in most cases the front end—what was termed the front end commission of 50%.

Q. But that was provisional, wasn't it?

A. So-called provisional.

Q. In other words he got something in advance. Now would you contrast that with your statement in which you said "no provisional commission was given to Georgia Life".

A. None was under the reinsurance agreement. No provisional commission was allowed Georgia Life. Georgia Life ceded. . .

Q. Then the agent had a better deal than Georgia Life?

A. I would say so.

Q. The agent got, he got an advance. . .

MR. LUYTIES: Your Honor, I object to this on two grounds. First of all we are getting into an area of leading questions, and secondly I don't see the relevancy of the commissions to the agents, how they are determined. We are talking about the agreement between the Georgia Credit Life as primary writer, and the reinsurer, Georgia Insurance.

THE COURT: All right, sustained.

Q. Would you look at Exhibit 12 and tell me whether liquidation was provided for?

[20] A. Yes. In Article 2, Liability of Reinsurance.

Q. By reading that paragraph in the contract, what would have happened if Georgia Life had went into receivership?

A. Well under the—under the terms of this contract that Article 2 contains an insolvency clause which at that time was recommended by the National Association of Insurance Commissioners and further required by the insurance laws of the State of Georgia in every reinsurance contract.

Q. Did you regard the possible insolvency of Georgia Life Company as a real possibility?

A. As a possibility. How real would be difficult to say. I mean real in the sense of immediacy or urgency. We considered it a real possibility in the sense that we couldn't predict the future.

Q. If I read from that clause there is a direct responsibility to reinsurance company, now is there any other risk which was real as far as Georgia Insurance Company was concerned?

A. Well I think in the insolvency clause—I think that is a very real and present risk. In the event—in the event of insolvency of the Life Company, the primary writer, even adjudged bankrupt, the liability of the Insurance Company for the 70% they had assumed did not cease. It continued.

Q. Did you have a loss experience in the case of any individual agency which exceeded 96%?

A. A number of them, yes.

[21] Q. Would you refer to the N.A.I.C. handbook, just in your testimony—I don't know whether you have read it or not—are you familiar with what is known as a surplus aid contract?

A. Yes.

Q. Was this in your opinion a surplus aid contract?

A. No.

Q. Why was it not a surplus aid contract?

A. Because there was no provisional—there was no provisional commission or tentative commission involved which resulted in any immediate increase to surplus.

THE COURT: Say that again.

A. There was no tentative or provisional commission involved that resulted in any immediate increase to the surplus of the Life Company upon the cession of these premiums. In other words, the Life Company, they ceded the premiums over, they got nothing in return at that point.

Q. Was there—as a result of this agreement, was there ever any increase at all due to the result of the agreement because of this reinsurance?

A. No, there was not.

Q. In the sense you use the term “surplus relief”, did you use that term? Did that seem to perhaps be a better utilization of surplus?

A. Surplus relief in a broad sense can, I believe, go back—in my opinion, you can go back to one of the business reasons [22] for negotiating a treaty of this sort, which I referred to earlier—that is net written premiums—the ratio of net written premiums to surplus. I mean . . .

Q. But there is no actual increase in surplus?

A. There is no actual dollar increase, no.

Q. Now if there had been a provisional ceding of the commission before the commission was earned from Georgia Insurance to Georgia Life what affect would that have had on the surplus?

A. That would have resulted in an immediate increase to surplus. As soon as—upon the cession of the premiums surplus would have been enhanced.

Q. The absence of the provisional commission then is the reason that it is not a surplus aid contract?

A. Yes.

Q. Is that consistent with the definition that you find of surplus aid in the N.A.I.C. handbook?

A. Well in the N.A.I.C. handbook I find that the definition of surplus aid treaty is one that results in an immediate increase to surplus. This did not occur under the terms of this treaty.

THE COURT: Where is that definition in this handbook?

A. Your Honor, it may be . . .

MR. HARPER: It's either 17 or 19.

MR. LUYTIES: I believe they are referring to page B 14, first of all.

[23] MR. HARPER: Yes, surplus aid is B 14.

A. B 14.

MR. HARPER: You may examine.

CROSS EXAMINATION OF MR. PHILLIPS

BY MR. LUYTIES:

Q. Mr. Phillips, could you demonstrate what you mean by surplus relief or surplus aid again to the Court?

MR. HARPER: I object to using those terms interchangeably. They are not so interchangeable.

THE COURT: I'm not so sure . . .

MR. HARPER: It will confuse this record.

THE COURT: I'm not so sure that he meant it that way. He may be asking to . . .

MR. HARPER: Would you read the question back.

THE COURT: Well he said "explain to the Court the meaning of a surplus aid or a surplus relief contract". I am not so sure that he meant them to be the same. Let's see what the witness says.

Q. Mr. Phillips?

A. A surplus aid contract as set forth here, I explained it, in this manner. It is a reinsurance contract basically whereby the surplus of the ceding company is immediately enhanced basically by the conversion of deferred income into current income, usually through means of commission, [24] of reinsurance commission.

Q. And you are saying that the reinsurance agreement in question was not a surplus aid contract?

A. Not a surplus aid contract.

Q. Was surplus relief provided by this contract?

A. In a broad sense—very broad.

Q. In what . . .

A. Not in a dollar sense, no.

Q. Not in a dollar . . .

A. Not in a dollar.

Q. Then what do you mean by surplus relief, and how can it benefit a company if not in an economic sense—not in a dollar sense?

A. Well in this sense. As I said management was concerned with keeping a reasonable ratio of—I—my memory, I can't recall precisely, but I would think somewhere in the range of maybe 3 to 4 to 1 ratio between net written premiums and surplus and capital.

Q. And what does that mean? What is the benefit of keeping the ratio at that level?

A. I think there are benefits in it. The—I would hate—I mean in my own opinion—I would dislike very much to see a company capitalized at \$400,000.00 go out over a period of three years and put \$10,000,000.00 business in force with none of it reinsured?

[25] Q. Did that happen in this case, even with the reinsurance agreement?

A. I don't believe that. I can't stipulate that those actual amounts occurred, but there was a substantial increase in volume over a period of a few years.

Q. Did premiums increase to approximately \$1,000,000.00 as of 1966?

A. I don't have the figures.

Q. Are you familiar with a letter which was sent from Herbert L. Parks, President, First of Georgia Insurance Group to Mr. Love that we discussed in a deposition back in January?

A. I believe I am. I am familiar with one letter. I assume that is the one you are referring to.

MR. HARPER: Let me see it.

MR. LUYTIES: Is that a copy of that letter?

A. Yes. I have seen this letter. Yes.

Q. And what is the premium volume noted at the bottom for 1966?

A. Premiums written of \$1,014,000.00—round figures.

Q. And for the years preceding 1966 were they lower or higher than that amount?

A. Lower.

Q. Now, assuming you had no reinsurance involved, you had premiums—and that's total premiums, is it not, Mr. Phillips?

[26] A. I will have to—I believe—I haven't read the letter closely enough, but I believe that this is only accident and health premiums.

Q. Is that . . .

A. I don't believe this includes life.

Q. Is that including reinsurance?

A. Yes, according to the letter, it does, yes.

Q. Would a range of \$1,000,000.00 to a surplus of \$400,000.00 be in the dangerous area?

A. I would not consider it to be.

MR. LUYTIES: Thank you.

MR. HARPER: If it please the Court, there are also premiums written on life insurance that are not in that figure.

MR. LUYTIES: Counsel, we can get into that on re-direct, I believe, at the appropriate time.

Q. Mr. Phillips, isn't it a fact that by entering into the reinsurance agreement that it did with Georgia Insurance, that actually there was a drain on Georgia Credit Life surplus by the amount of the commission it was paying Georgia Insurance?

A. Well, I—I think I would hesitate to use the word "drain". There was an expense reducing surplus, yes.

Q. Well, you have stated that there was no surplus aid, correct?

A. Correct.

[27] Q. There was no tentative commission that could have been immediately realized by Georgia Credit Life in—in aid surplus? Correct?

A. True. True.

Q. On the other hand, due to this commission that was going to be paid Georgia Insurance, did not this act in reverse and create a drain, a slight drain perhaps, but a drain?

A. Well, if I may clarify it, I don't consider the amount earned by Georgia Insurance a commission, but

Q. That is all right as far as the characterization of the term.

A. But the dollar amount you are referring to, yes, it resulted in a reduction to surplus, yes.

Q. Mr. Phillips, did Georgia Credit Life, under the way the agreement worked out in practice, as far as determination of the commissions, did Georgia Credit Life bear the risk of loss on the insurance reinsured up to 96% of the earned premiums?

A. Did Georgia Insurance . . .

Q. Did Georgia Credit Life bear the risk of loss up to 96%?

A. In my opinion, no.

Q. We started with a hypothetical earlier of \$100.00 in premiums. Can we follow that through. Assuming we have \$100.00 in earned premiums, you stated that the commission to Georgia Credit Life would be 96% of that minus the losses?

A. You are assuming that—you are making the assumption that [28] the \$100.00 represents the earnings on the 70%?

A. Yes, sir.

Q. Assuming then also a loss experience of \$20.00 in the previous quarter, you determine the—you would in that case, I take it, determine the commission to be \$96.00 minus \$20.00 or \$76.00 to the primary writer, Georgia Credit Life. Is that correct?

A. Correct.

Q. And by the same token, the commission to Georgia Insurance would be \$4.00, is that correct?

A. The earnings of Georgia Insurance on the retained business would be \$4.00.

Q. Okay, you prefer to use earnings?

A. Yes.

Q. Assume that losses increase to \$25.00. In that case, what would be the commission to Georgia Credit Life?

A. \$71.00.

Q. That would be a decrease of \$5.00. Is that correct?

A. Right.

Q. As losses increased, the profits in the form of commissions to Georgia Credit Life would decrease dollar for dollar, is that correct?

A. This is true. This is correct.

Q. But yet you still say that Georgia Credit Life did not bear the risk of loss up to 96% of the earned premium?

[29] A. In my opinion, no.

THE COURT: Would you explain that, please?

A. Me, sir?

THE COURT: Yes, sir.

A. Your Honor, as I understand it, Mr. Luyties, apparently his question is whether or not First of Georgia Credit Life sustains the loss because it—ultimately in a retrospective commission calculation, the commission is absorbing the loss, up to a point. I don't subscribe to that theory. Mechanically, the calculation will work that way, but I don't subscribe to that theory because in my opinion First of Georgia Insurance Company is definitely and realistically responsible for its 70% of the business they assumed; so I think this may be a matter of semantics, but I can in no way see how the First of Georgia Credit Life is bearing the risk.

THE COURT: Well, if they have to pay up to 96%, why aren't they?

A. Well, if I may draw a parallel, I will try to compare them. We had an agency force that—a very similar contract to this—we would grant—First of Georgia Credit Life would grant them a figure of 87½% of their earned premium, against which losses incurred within their agency were deducted. The balance was the agent's commission. I consider it very very similar to this, yet in no way was the agent [30] bearing the risk. The agent is not an insurance company. He cannot legally bear the risk. He cannot legally insure the risk. The policy holder had a contract which he could only recover on—under the terms of the risk, he could only recover from First of Georgia Credit Life, not the agent.

THE COURT: Well, I see it is a matter of semantics.

A. To a great extent, yes. The dollar amounts involved, you may say there is a reimbursement of the risk somehow, but the risk is actually borne, in the illustration I gave you, the risk is payable, of course, under the terms of the policy contract to the named insured. The named insured, he looks to one person for collection, First of Georgia Credit Life Company. Then under the terms of the contract, and even involving the insolvency clause, First of Georgia Credit Life looks for a reimbursement of 70% from First of Georgia Insurance. So to me it is a ladder that you go rung by rung.

Q. Mr. Phillips, how in practice did the agreement with the agents work out? Were their commissions always adjusted retrospectively in view of the loss experience?

A. Yes.

Q. You are referring to what, finance companies?

A. Basically, yes. Primarily finance companies, yes, sir.

Q. So you are saying that after a \$50.00 or 50% provisional [31] commission was paid, that in all events the commission to the agents would be increased as the loss experience was . . .

A. Increased if there was a satisfactory loss experience to result in an increase, yes sir.

Q. What if the loss experience were unsatisfactory. What would happen to that \$50.00 or 50% commission?

A. The only way we could hope to get out on that would be to stay with the agency if we could.

THE COURT: Would you set it off against future premiums?

A. Yes. Yes. If there were future earnings there against which to do it, yes.

Q. Is this what happened in practice?

A. Yes.

Q. And what happens when you couldn't set it off against future earnings?

A. It was a loss. A loss to us. We had, I recall, a number of cases where that did happen, one specifically for a substantial sum of money, and we could not recover, and business conditions were such that we thought it imprudent to stay within the agency, because we felt it would get worse instead of better.

Q. How long were you involved with Georgia Credit Life?

A. From its inception in 1958. I believe the date was December 1, '58, but anyway from its inception in 1958 until August of 1966.

[32] Q. During the time January 1, 1962 through August 1, 1966 was there ever a quarter in which the losses on credit accident and health insurance exceeded 96% of the earned premiums?

A. Not to my knowledge.

Q. What in fact did the loss ratio generally amount to?

A. As I recall from—more recently from looking at records, somewhere in the range of 23, 25, 27 percent.

Q. Were dividends declared by Georgia Credit Life during any of the years in which you were working for Georgia Credit Life?

A. Yes.

Q. What were those dividends and what years?

A. I would have to have . . .

Q. Perhaps I could refresh your . . .

A. . . . I would have to refer to documents to recall the amounts and dates.

Q. Do you recall stating in your deposition that there was a \$16,000.00 dividend declared and paid in 1959 by Credit Life?

A. Yes, I seem to recall that.

Q. Do you recall that there was a \$31,500.00 dividend in 1960?

A. I seem to recall that also.

Q. Do you recall that there was a \$50,000.00 dividend paid in the year 1963?

A. I seem to recall that—I can't, as I say I can't be sure of [33] the amounts or dates. There were dividends paid.

Q. All right. I believe you said 1962, on deposition, that the annual statement reflects the dividend in 1963, so one of those years there was a \$50,000.00 dividend, is that correct?

A. The dividends as reflected by the annual statements that were filed, yes, they were correct.

MR. HARPER: These are a part of the record, aren't they? Are they exhibits?

MR. LUYTIES: We haven't introduced any exhibits yet.

MR. HARPER: Well, we better get the stipulation in.

MR. LUYTIES: I have no objection to the stipulation together with the 21 exhibits being introduced at this point.

THE COURT: What is the stipulation? State it for the record.

MR. HARPER: The stipulation is that the—the motion is that the Court would receive the stipulation of facts and twenty-one exhibits attached thereto into evidence in this proceeding.

THE COURT: Well, where are those stipulations?

MR. LUYTIES: Right here, Your Honor.

THE COURT: All right, any objections to these stipulations?

MR. LUYTIES: No, Your Honor.

THE COURT: Then let them be received in evidence.

MR. LUYTIES: Let us introduce the exhibits that go along with the stipulations.

THE COURT: Yes.

Q. Mr. Phillips, one last question about the dividends. What [34] is the effect of a dividend payment on the surplus of the company?

A. Of the life company?

Q. Yes.

A. The life company paying the dividend?

Q. Yes.

A. It is a reduction of its surplus.

Q. Directly reduces it?

A. Directly reduces it.

Q. The Piedmont Life Insurance Company reinsurance agreement you referred to earlier, is that correct?

A. Yes.

Q. What in general were the terms of reinsurance under that agreement? First, who was the reinsurer?

A. The rein—if I may go back and take it at the beginning . . .

Q. Yes, sir.

A. There was a block of business, a block of life insurance business produced by Georgia Railroad Bank that for management reasons the management elected not to write this business directly, but to have Piedmont Southern in Atlanta write the business directly and reinsure it 100% with Georgia Credit Life.

Q. And what were the terms of the reinsurance agreement as far as liability assumed and commissions determined—those two things?

[35] A. The terms were that Georgia Credit Life would reinsure 100% the liability of Piedmont Southern, and that Piedmont Southern would retain 7%, as I recall, I believe the 7% figure is correct, out of which they paid their expenses.

Q. So in that case the reinsurer, and that was Georgia Credit Life acting as the reinsurer, is that correct?

A. Correct.

Q. In that case its profits as a reinsurer were directly dependent on its loss experience or the loss experience of Piedmont Life, is that correct?

A. Yes.

Q. In that case, is it your opinion that Georgia Credit Life was bearing the full risk of losses?

A. Yes.

MR. LUYTIES: Thank you, I have no further questions.

THE COURT: I have one. You stated in response to one of his questions the result of this contract, the treaty between the two companies, was actually to reduce slightly the surplus available to Georgia Credit. Well how then did this arrangement make it possible for them to expand? You know—it was a good—how did it make it possible for them to expand?

A. Well our management felt this way, that basically it was an untried business with Georgia Life at the outset. We, our management consisted of, primarily of fire and casualty [36] people. Life, accident and health was a relatively new field to our management team. We felt that we would be called on—we would be confronted with writing a rapidly expanding volume of this business, and we felt that by reinsuring, it would spread the risk and give us a much broader base from which to work.

THE COURT: How would this do that?

A. Well it would do this, Your Honor. We were—I guess its a matter of numbers. In most insurance risks, unless they are specialized, the larger, what we call the base, but the more numbers you insure, the more your results tend to stabilize.

THE COURT: I understand.

A. It's a matter, I suppose, of statistics. For example, I think probably—and I am not a life insurance expert—but I think probably in one individual life insurance risk, I think probably the standard mortality tables could go very well haywire. In the case of a thousand, they would be more reflective. Ten thousand, and I suppose somewhere short of infinity, they would be precise.

THE COURT: Well, assuming that's so, then how again does this make it possible for Georgia Credit to expand its business further because of this agreement?

A. Well, we felt that we could not . . .

THE COURT: If its capital is decreased slightly, I mean [37] again how does it help it?

A. We—we felt this, Your Honor. We felt that we would be unable and unwise to write the volume of life and A & H business, which was relatively new lines to us, in the volume that we were anticipated writing it without reinsuring.

THE COURT: All right. That's understood, but wouldn't it have been a better practice from the standpoint of its own future liability if the risk on that reinsurance actually followed the premium, if the risk actually went in fact to Georgia?

A. The risk in fact went to Georgia.

THE COURT: Well, only beyond 96%, did it really?

A. Well, it's the illustration we had a while ago, a matter of semantics.

THE COURT: Well, I know, but still we are talking about the actual result to a company that makes it more able to expand. Now, this is what I don't understand. Now, I can understand the desire of your customers to have a single package was desirable. This is a real legitimate purpose, regardless of any other reason, but I still can't quite understand how this specific contract between you actually made it possible for you to expand more—that is for Georgia Credit to expand more—expand more quickly. How did it?

A. Well, we expanded more on a—in matter of gross premium [38] production, we were able to expand more.

THE COURT: Why? What difference did it make whether or not you had this reinsurance . . .

A. Because the capital structure—no—because the capital structure of our company was at risk only to the extent of the 30% we retained.

THE COURT: Well, immediately; but yet you still had the—I won't even say contingent risk—the only contingency here was that maybe your agent's premium would absorb the loss, but insofar as . . .

A. I would absorb it to an extent, yes.

THE COURT: But it would anyhow.

A. Yes, it would.

THE COURT: It would anyhow. But beyond that, between that figure and the 96% figure, no. It was fixed; you had it. You didn't shift it by this agreement.

A. In my opinion, the risk was shifted.

THE COURT: Well, yet when there was a loss, you paid it, not First of Georgia.

A. That in turn—in turn, I think following that context of thinking, you can say that when there was a loss, the agent paid it.

THE COURT: Well, he really did up to, you know, his . . .

A. But certainly—certainly under insurance laws, the agent had no risk.

[39] THE COURT: No. He had no risk as insurance law would be characterized, but in fact, he paid it.

A. In fact—well, as I see it—and I guess we are getting into semantics again—as I see it, it's a factor in the calculation of his commission.

THE COURT: All right. But honestly, Mr. Harper, I still can't understand how this agreement made it possible for them to expand more.

MR. HARPER: We will develop this further through the next witness.

THE COURT: Good. All right.

MR. HARPER: Actually the President of the company, who is an insurance man who dealt with people, will be able to answer that more fully, and I hope to your satisfaction.

THE COURT: All right.

REDIRECT EXAMINATION OF MR. PHILLIPS

BY MR. HARPER:

Q. On cross examination, you testified about a reinsurance agreement between Piedmont Southern and Georgia Life. Now, you said that approximately 7% was the percent there. Now, what would be the maximum that could be realized between these two—we have got two maximum commissions, 87½% to be paid out as an expense, first risks and second commissions [40] to be paid out to the agents, and 96% could be realized. What is the maximum that Georgia Life could get out of this 100% of the premium?

A. Well, basically . . .

Q. Percentage?

A. Well, basically . . .

Q. On the reinsured amount?

A. Basically . . .

MR. LUYTIES: Excuse me. I don't understand the question. Is this the Piedmont Agreement or the Georgia Credit Life during its . . .

MR. HARPER: That's the Georgia Credit Life. I want to compare, and the question I have asked is to give us a figure which would be comparable.

MR. LUYTIES: Where do you get the 96%?

MR. HARPER: The 96% is the maximum commission that's available on the reinsurance.

MR. LUYTIES: Under the agreement between Georgia Insurance and Georgia Credit Life?

MR. HARPER: That's right.

MR. LUYTIES: Are you talking about that one or the one between Piedmont Southern . . .

MR. HARPER: I am talking about that one.

MR. LUYTIES: Thank you.

Q. On this reinsurance agreement between Georgia Insurance and [41] and Georgia Life, there is a maximum of 96%, you testified, which would cover losses and commissions to Georgia Life. That's their income. Now, the expense on the other hand is commissions to the agents. What was the maximum under that?

A. It would be 87½%.

Q. $8\frac{1}{2}\%$ was the spread. Now, from that, what amounts had to be paid? What expenses did Georgia Insurance—Georgia Life . . .

A. All . . .

Q. What expenses did Georgia Life Insurance Company bear?

A. Georgia Life Insurance?

Q. From that $8\frac{1}{2}\%$?

A. They bore all expenses.

Q. That's—those premiums, those expenses—

A. They have to—from the $8\frac{1}{2}\%$, they would have to bear all expenses other than the losses.

MR. HARPER: I have no further questions. You may come down.

NOTE: The witness withdrew from the stand.

MR. HARPER: I would like to call Mr. Herb Parks to the stand.

MR. HERBERT PARKS took the stand, and having been duly sworn, testified as follows:

DIRECT EXAMINATION OF MR. PARKS

BY MR. HARPER:

Q. Would you state your name and address for the record, please?

[42] A. Herbert Parks, Jacksonville, Florida.

Q. What is your business Mr. Parks?

A. I am Chairman of the Board and President of Peninsular Fire Insurance Company.

Q. Did you ever have any connection with the company that we are using here—the name Georgia Insurance Company?

A. Yes, I went to work for Georgia Insurance Company in 1958.

Q. The name of it at that time was what?

A. First of Georgia Insurance Company.

Q. I will just use throughout Georgia Insurance to indicate that company. That business was—of Georgia Insurance was what in 1956?

A. Property and casualty insurance in 1958.

Q. In what capacity did you serve that company?

A. I went with the company as Superintendent of Agents. I was in charge of producing business for the company.

Q. Did you remain with that company until—when did you leave the employ of the company?

A. Late in 1968.

Q. To what executive positions did you rise in this sequence?

A. I was promoted to Vice President and became President the middle of 1964.

Q. Are you familiar with the inception of the corporation which we know as the Georgia Credit Life Company?

A. Yes, I was largely responsible for . . .

[43] Q. Did you . . .

A. . . . the creation of that company.

Q. In what sense do you say you were responsible for it?

A. Well we could see the opportunity to write a class of business in which we thought we could make a profit. It was business that could not be written individually by the property and casualty company. It required . . .

Q. All right, could not—why couldn't the property and casualty company write it?

A. Well, this was credit life and credit A & H insurance. Credit life insurance can only be written by a company that's chartered under the statute as a life company.

Q. We have stipulated in Exhibit 12, which is the reinsurance agreement. Would you explain the circumstances under which this agreement was entered, and who the parties were to that agreement.

A. Well the parties to the agreement were First of Georgia Credit Life Company and First of Georgia Insurance Company. The Life Company for good reasons was organized at a minimum capital and surplus and it's quite customary in our business to—in getting started, as we had done originally with the insurance company, to lay off a part of the risk. Our business is based on the law of large numbers and until you create a credible bulk of business you are running at heads with it

disproportionate to the amount [44] of gain you may realize.

Q. Would you look at that reinsurance agreement and tell us specifically how you went about deciding what a proper agreement would be and how it was drafted, how that agreement was drafted?

A. Well, Mr. Harper, we plagiarized much of the agreement. We had a very small organization. As I recall at that time, there were probably about 14 employees, and we weren't particularly sophisticated in the reinsurance field. We contacted, as I recall, three or four reinsurers to see what they could do in the way of providing us some safety as we went . . .

Q. Would you say that contract as finally written was comparable to in its terms, its conditions, and its elements to contracts usually in business?

A. Yes, I would say for the most part it was copied word for word after contracts that we had in our hand.

Q. Now, as has already been testified, you originally ceded 60% of the A & H Business. Would you describe first what part of the A & H business was reinsured?

A. Well, it could be referred to interchangeably as small loan A & H or industrial loan A & H. This is business that was and is today produced by lenders, finance companies, who are licensed under the small loan or industrial loan acts of various states.

[45] Q. What percent of the total business did the small loan, or industrial loan A & H comprise of the total A & H business?

A. It represents a lion's share. I would say well in excess of 90%—maybe 95 or 98 percent.

Q. Would you tell the Court what business considerations led you to decide on this quota share of 60%?

A. Yes. It wasn't easy trying to get that life company licensed, and particularly not for minimum capital and surplus. We were cautioned about writing too much business eventually, so one of the reasons was to maintain a reasonable ratio of net written premiums to policy holder surplus. The Insurance Departments applied a rather stringent rule . . .

Q. You are talking about the State of Georgia and others . . .

A. Well, others. Most of the policy . . .

Q. What is the significance of that ratio?

A. Well, to the Insurance Departments and others who judged your statement, it was an indication of solvency; ability to stand up to your liabilities.

Q. Were you ever specifically prohibited or cautioned about further expansion because of this ratio?

A. Well, we weren't specifically cautioned about further expansion, but we were cautioned not to overwrite.

Q. What would a satisfactory ratio have been?

A. The Insurance Departments felt that as long as you were writing one-and-a-half in net written premiums and one- [46] and-a-half times your policy holders surplus, that you were on firm ground. They might let you go to two. If you went beyond two, they would come in and stop you from writing additional business.

Q. The Insurance Department of the states?

A. Yes, that's right. To a large degree, that rule is still invoked by a number of states.

Q. And it still affects your company . . .

A. Yes, it does. And, of course, another reason was the spread of risk. We were embarking in a new area of business in which we had had very little expertise. As I recall, I was the only one in the organization who had been exposed to it at all. We thought we could make money in this, but there was no guarantee in that, so we wanted to lay part of that risk off.

Q. Did you think that the 96% was a reasonable figure to decide on, which left a 4% of the overall premium for the reinsurer?

A. Yes, sir. This was the best offer we had from the reinsurance market, outside of our own group of companies, when we went to those companies, and the reason we decided to use our own was because we—first we had to assume—we wouldn't be writing that business if we didn't think it would make a profit, and if we were merely going to pass profit on to someone else, we might as well keep it within our [47] organization.

Q. Are you familiar with the term "surplus relief contract" as that it is used in the N.A.I.C. Handbook?

A. I think you are referring to surplus aid contracts, and yes, I have read that provision in the N.A.I.C. Handbook.

Q. Was this in your judgment a surplus aid contract?

A. No, we did everything we could—we were very aware at that time that there was a lot of pressure within the industry by other state insurance departments to attack surplus aid contracts, and the two chief ingredients in a surplus aid contract was a large front end commission and a guaranteed profit to the reinsurer.

Q. A large front end commission to who?

A. To the ceding company—to the primary insurer.

Q. Well, why do you say that there wasn't a large front end commission to our primary insurer?

A. Well, I started to say, Mr. Harper, that these are the two areas we attempted to avoid so that we . . .

THE COURT: One is a secondary and one is a large front end commission. What is the other?

A. The other is a guaranteed profit to the reinsurance company, Your Honor. These were the two areas we purposely tried to avoid, so that there would be no stigma attached to our dealings as far as inter-company relationship was concerned.

[48] Q. Is there any specific provision that is missing from that general—that reinsurance agreement Exhibit 12 that would make it not a surplus aid contract?

A. Yes, there is no guarantee of profits to the reinsurer.

Q. And there is no front end or provisional commission?

A. No.

Q. How did the primary insurer realize its share of the commissions?

A. Well, of course, it retained a portion of it, and as long as the loss ratio remained within the established limits it realized a profit on that portion that was ceded to the reinsurance.

Q. As earned?

A. As earned. We felt that the reinsurer's risk was proportionate to the maximum amount that it could earn.

Q. Would you tell the Court whether this reinsurance agreement, Exhibit 12, resulted in an increase in surplus in any sense?

A. No, it did not.

Q. Was this—was Georgia Credit Life audited by the examiners of the State of Georgia . . .

A. Yes.

Q. . . . during your term as President?

A. Yes, it was.

Q. Did they go into the reinsurance agreement specifically?

A. They certainly did.

[49] Q. Did they approve that?

A. They did. They audited the company at the end of 1964, and I had become President by 1964. They examined it again at the end of 1967 . . .

MR. LUYTIES: Your Honor, I am going to object this.

THE COURT: Yes, well of course they are more concerned with protecting the policyholder, rather than the mechanics by which you do it.

MR. LUYTIES: Also, to the extent that the opinions expressed by these examiners, I am going to object to this as hearsay. We don't have these . . .

THE COURT: Well you don't dispute that this arrangement was accepted and approved by the State of Georgia, do you?

MR. LUYTIES: I dispute that it was fully considered, yes.

THE COURT: Well, again, they didn't disapprove of it did they?

MR. LUYTIES: That's correct. They did not disapprove . . .

THE COURT: Well, this . . .

MR. HARPER: If it please the Court, by deposition here, to which there is no objection . . .

THE COURT: All right, we've covered that.

MR. HARPER: . . . the Chief Examiner has testified and has indicated the extent of the studies and indicated his interest.

THE COURT: All right.

[50] MR. HARPER: You may inquire.

CROSS EXAMINATION OF MR. PARKS

BY MR. LUYTIES:

Q. Mr. Parks, were there any other advantages or business reasons behind the reinsurance agreement, other than those you have already enumerated?

A. From an underwriting standpoint, no. I can't think of any.

Q. From an economic standpoint—from the financial viewpoint of Georgia Credit Life?

A. Well, obviously, it retained the tax status of a life company as a Life Company.

Q. The tax advantages were considered at that time?

A. Well, we didn't take advantage of that status to the fullest or we would have provided a large front end commission contract.

Q. Were they considered at that time, the tax advantages?

A. It was certainly discussed. Yes.

Q. Now, when I talked with you on the phone a week or two ago, we discussed surplus relief—or surplus benefits afforded by this reinsurance agreement, and at that time, didn't you state that in your opinion there were surplus benefits afforded by the reinsurance agreement?

A. Yes, I did, but you know, that's going back ten years, and that's a long way back.

[51] Q. And wasn't it also your statement that in fact there was a financial and economic benefit to the surplus of the company upon entering into this reinsurance agreement?

A. I don't recall that, no.

Q. Well then, in your opinion, was there surplus relief provided by this agreement?

A. Only in the sense that it relieves the pressure on surplus, as a measure in relationship to the amount premiums already written.

Q. Was there any?

A. Are you saying did it serve to increase the surplus of the Life Company?

Q. Did it serve to increase the surplus?

A. No, because there was no front end commission.

THE COURT: Only from potential exposure, you see, the way you handled the surplus?

A. Yes, sir.

Q. Did it in fact serve to decrease the surplus of the Credit Life Company?

A. Yes, to the extent that the commission or the retention on the part of the reinsurer came out of earned premiums.

Q. To that extent, there was a negative surplus benefit, is that correct?

A. Yes.

Q. You mentioned before two aspects of this contract that are [52] different from surplus aid agreements. First of all there was no provisional coverage commission, an immediate commission to the primary writer.

A. Yes, sir.

Q. I don't believe you can dispute that. That's in the terms of the contract isn't it?

A. That's right.

Q. It says "no provisional coverage commission shall be afforded", is that correct?

A. I believe that's right.

Q. Secondly, though, you said that there was no guaranteed profit. Now in a guaranteed profit contract does the contract say we guarantee 4% commission to the reinsurer?

A. Yes, may I give you a narrative answer?

Q. Yes, sir.

A. I have been involved in guaranteed profit contracts, not with First of Georgia, but with other companies, and the guarantee is clearly stated.

Q. What wording was used?

A. Well it simply stated that regardless of the underwriting experience the ceding company guarantees the reinsurer "X" percent of profit.

Q. Are you familiar with the example in the N.A.I.C. Examiners Handbook regarding guaranteed profit contracts?

A. I have read them, yes.

[53] Q. Would you like to refer to that?

A. I was just fixing to say I would be. . .

Q. Pages B 14 through B 16.

A. Is there a particular portion of these pages you would like me to. . .

Q. Yes, on B15 there is an example of a guaranteed profit contract—commission at 45%. I assume that is the tentative commission that we have been discussing that was not included in this agreement?

A. Yes, they refer to that as a tentative commission contract.

Q. Ceded for reinsurer in the lost ratio -“breaking point at 52%?”

A. Right.

Q. Now, excluding this tentative commission. . .

MR. HARPER: We are short a copy of that. Do you have an extra copy of that? We need it to follow the testimony, if it please the Court. I gave him my copy.

THE COURT: All right.

Q. I believe I attached your copy. . .

THE COURT: Yes, in that instance the 3% figure, is that the guarantee?

Q. That was my question, is this the guaranteed portion Mr. Parks?

A. Of course we are not looking at a contract here, we are [54] looking at a description of a contract.

Q. Right.

A. What they are saying here, if it were a contract, it does not guarantee a profit to the reinsurer. They are just—they are describing a formula, rather than a contract that would be executed between parties.

Q. Well, are they not describing a commission determination which is indicative of the guaranteed profit arrangement?

A. I don't see it that way. I don't see the guaranteed provision in here.

Q. All right. Now up to 96% of the earned premiums under the reinsurance agreement between Georgia Credit Life and Georgia Insurance Company, is it correct that the profits in the form of commissions to Georgia Credit Life were reduced dollar for dollar according to the loss experience?

A. Yes, that's true. The commissions—the commissions to be paid by the Insurance Company to the Life Company were reduced.

Q. And by Insurance Company you mean the reinsurance company?

A. Right.

Q. In view of that, isn't it true that Georgia Credit Life bore the risk of loss on even the A & H reinsured to the extent of 96% of the earned premiums.

A. It's hard for me to think of it in that terms, because the reinsurer was required to pay a pro-rata share of losses paid, [55] and to set up a reserve for the outstanding losses which yet remained to be paid.

Q. Well, according to the contract, it wasn't required to set up a reserve, but it was for the terms going to accept 60 or 70 perent "it's share of the net liability". That's correct, isn't it?

A. Yes.

Q. But the way the commission's determination worked out, wasn't it true that in practice at the end of each quarter that it turned out that Georgia Credit Life had borne the risk of loss on the losses up to 96%?

MR. HARPER: Read that question back again.

MR. LUYTIES: Do you want me to ask it. . .

THE COURT: Go on, rephrase the question, or restate it.

Q. Mr. Parks, then wasn't it true that at the end of each quarter that in fact under the commission formula that Georgia Credit Life had borne the risk of loss on all losses up to 96% of the earned premium?

A. It was certainly true that the reinsurer would not have suffered an economic loss unless the loss ratio had exceeded 100%. Is that the same percent that. . .

Q. Yes, that's close enough. In the event the loss exceeded 100%, however, there was another provision in the contract, was there not?

A. The carry-over provision?

[56] Q. Yes, the debts and carry over provision.

A. Which is quite common in all reinsurance contracts.

Q. And in that event, in the event of a deficit, losses in excess of 100%, is it not also true that Georgia Credit

Life would bear the losses to that extent if in a subsequent quarter or quarters the other losses dropped down below. . .

A. The loss ratio improved?

Q. The loss ratio improved, and it had dropped below 96%?

A. Sure. Reinsurers are going to make money normally in this business.

Q. And in fact the contract provided that the reinsurer's commissions were to remain constant at 4%. Is not that correct?

A. Well, that was the maximum the reinsurer could make.

Q. But aren't—isn't that the wording of the agreement?

A. No, not at all.

Q. Will you refer to the agreement, please?

A. That the reinsurer's commission was remaining constant at 4%?

Q. Yes.

A. What portion are you referring to?

Q. That's Exhibit A, Section 5, the end of the first paragraph. You can start after that last semi-colon. . .

A. Yes, it does say—it says that the reinsurance commission will remain constant at 4% of the reinsurer's earned premium.

[57] Q. Mr. Parks, how long were you associated with Georgia Credit Life?

A. From the organization of the company at the end of 1958 until November of '68.

Q. During that period of time, and during the period of time that the reinsurance agreement was in effect, was there ever a quarter that the loss ratio exceeded 96% on the reinsured policy?

A. To the best of my knowledge, there was not.

Q. And in fact wasn't the loss ratio usually about 20 to 30 percent?

A. Yes, that is correct.

Q. And isn't it also true that during that period of time, Georgia Credit Life would not even have written credit A & H business had its expected loss ratio have been as much as 40 to 45 percent?

A. No, we wouldn't have gone into it if we had thought the loss ratio would have been greater than what it turned out to be.

Q. Would have been even greater than 40%, is that correct?

A. We wouldn't have gone into it if we had thought the loss ratio was going to be 40%.

Q. Or even over 30 percent?

A. That's true. But that's probability you are talking about there.

MR. LUYTIES: I have no further questions.

[58] REDIRECT EXAMINATION OF MR. PARKS

BY MR. HARPER:

Q. Mr. Parks, I would like to use the term operating losses. I would like to ask you from accident and health insurance sold by the Georgia Life, were there operating losses realized by that company in the years?

A. Yes, I recall four years specifically in which the A & H line produced a statutory of earning loss.

Q. Were these the first four years?

A. Yes, for all practical purposes, they were the first four years.

Q. I hand you this and ask you if it reflects the fact that we are talking about?

A. Yes, this starts at '61, and as I recall, we had a loss in A & H in 1960, as well.

Q. I notice the last year there, 1964, is gained. Would you explain to the Court the effect of the business done—the volume of business done upon this in which you finally rise to a profit?

A. Well, statutory accounting requires you to charge off expenses as incurred and to defer paying income over the life of a policy, so that if you write \$100 in premium, you immediately incur the commission expense which is charged against the income and set up a \$100 unearned premium reserve. So at that moment, you have a statutory operating [59] loss.

Q. The volume of the business as it—well, how much did the volume increase during the time your were principal officer?

A. It increased rather dramatically.

Q. Just approximately.

A. I believe it rose from something like \$66,000 in 1960 to over a million dollars within four years.

Q. Did the reinsurance agreement and its application lend to that increase in volume insofar as your ability to write it?

A. Yes. The Georgia Department would not have let us grow at that rate if we had not ceded written premiums.

MR. HARPER: No further questions.

THE COURT: Well, is this the way that the agreement made it possible for you to expand more rapidly?

A. Yes, sir.

THE COURT: Are you through?

MR. LUYTIES: No, I want him to clear up this Exhibit 23. Has that been introduced in evidence?

MR. HARPER: I identified both 22 and 23 and I would like to offer them.

THE COURT: Well what is 23? You have never told me what that is.

MR. HARPER: 23 is the results of operations extracted from the annual statements submitted to the State of Georgia for Accident and Health . . .

[60] THE COURT: How much money earned or lost they made out of accident and health?

MR. HARPER: That's right. And also shows Credit Life Insurance Accident and Health.

THE COURT: Now, 22, that was that letter . . .

MR. HARPER: The letter from General Reinsurance, and I would like to offer both of those.

THE COURT: Any objections to those?

MR. LUYTIES: No, Your Honor.

THE COURT: All right, they are admitted without objections. All right, what questions do you have of the witness?

RECROSS EXAMINATION OF MR. PARKS

BY MR. LUYTIES:

Q. With regard to 23 in the determination of the net operating loss, Mr. Parks, now, this isn't just limited to incurred losses due to clients, is it?

A. No, it's not.

Q. This is due to commission, operating losses, other operating losses, overhead and also clients?

A. That's right.

Q. Now, if you hadn't entered into the reinsurance agreement with Georgia Insurance, wouldn't in fact the operating losses have been somewhat less due to the fact that you would not [61] have had to pay that 4%?

A. Minutely so, yes.

Q. Isn't it 4%?

THE COURT: Not immediately though.

MR. LUYTIES: He said minutely so.

THE COURT: Yes, I understood his answer, but I say it wouldn't immediately improve your net operating loss, would it?

A. Only to the extent of the 4% of ceded premiums, Your Honor.

THE COURT: Well then I am confused. How did it help you or permit you to write more insurance? How did it permit you to expand more rapidly, if each time you tell me it had a negative results—negative result?

A. Well, of course, Your Honor, the test was the ratio of net written premiums to policy holder surplus.

THE COURT: All right.

A. The 4% paid to the reinsurer was 4% on originally 60% and then later 70%, so 4% of say 70% is 2.8% of the premiums. Now, this was a cost to surplus, but starting out with a company with \$400,000 in capital and surplus, that meant that we could write \$600,000, 1½ times that amount, without receiving any kind of—you know—static from the Insurance Department. If we went to \$800,000, we are getting on the border line. If we exceed that, we are in—they are going to come in and tell us to stop writing it. Well, the 4% reinsurance ceded may have depleted surplus by a [62]

few dollars, but that in relation to the total premiums ceded, would just be minuscule in ratio.

THE COURT: Well, I see. All right.

A. It is just such a small amount in comparison to the total premium.

Q. Where did you get the $1\frac{1}{2}$ figure, Mr. Parks?

A. This is an axiom in our business, Mr. Luyties. I—all insurance departments—well not all of them, but most of them, to my knowledge, practice this today.

Q. Did someone from the Georgia Insurance Department tell you this?

A. Well, at the time we got the life company started, we were cautioned about writing too much business too quickly.

Q. Who told you that?

A. I don't recall who that was. Probably the Chief Examiner, and gee I wouldn't remember who that was. They were not happy about authorizing the organization of this company at a minimum capital and surplus position.

Q. Well, that was the minimum required by law, is that right?

A. Yes, that's right. Of course, the Commissioner has the prerogative of saying "no." He can say he is not going to issue license until you put in a lot more capital and surplus than that declared by law.

Q. Did someone from the Commissioner's office tell you at that time, in view of your \$400,000 capital position, that if you [63] wrote more than \$600,000 in net premiums, you would be in trouble?

A. Not in those words, no.

Q. Did they tell you that if you wrote more than \$800,000 in net premiums, you would be in trouble?

A. No, they did not, not in those words.

Q. What words did they use?

A. They cautioned us about writing too much business too quickly. What you are referring to though is something that is commonly invoked in our business and is today.

THE COURT: Well, is that sort of a rule of thumb in the business?

A. Sort, of, yes, sir. Even A. M. Best Company who publishes the Bible for life and property and casualty businesses still follows this practice in their test of solvency of insurance companies.

Q. So you are saying that even though you would be in—well, you wouldn't be in an improved position, and you would be in a slightly worse position so far as your surplus, despite this when you entered into this reinsurance agreement and could show that you were getting rid of some of the net premiums, 60 or 70 percent, this alone would get the insurance companies off your back a little?

A. The Insurance Department, yes, sir.

Q. Insurance Department.

[64] A. Yes, it permitted us to grow. No question about it. Otherwise the Department would have come in and stopped us from writing business. We do this today in my business in Jacksonville—for the same reason.

MR. LUYTIES: No further questions.

MR. HARPER: May I ask one other question.

REDIRECT EXAMINATION OF MR. PARKS

BY MR. HARPER:

Q. Weren't they—did they require of Georgia Insurance Company any added insurance? Weren't they worried about the formation of this, and didn't they restrict you in the formation?

A. There was a lot of conversation about that, Mr. Harper. It is awfully hard for me to reconstruct this thing. . .

Q. Wasn't there in fact an escrow of stock at that time?

MR. LUYTIES: Objection—leading the witness.

MR. HARPER: Well it is just going to take another witness, Your Honor.

THE COURT: Well it is leading, but I will allow it.

A. I recall something like that, but not the details. We had a difficult time getting the company formed.

Q. There were reservations on the part because of what, I mean what specific reason?

A. Mainly because we wanted to capitalize for such a small [65] amount.

Q. Now, when you refer to this critical ratio, are you referring to unearned premiums on both life and accident and health insurance?

A. No, this would be all written premiums, not unearned.

Q. All premiums?

A. Yes. I would like to say this if I may, Mr. Harper, that in setting the maximum 4% the reinsurer could earn on that contract, we tried to relate that to proportionate risk that that company bore. In retrospect, it is great the way it turned out, but the problems we faced as a very small group and not a very sophisticated organization was the possibility that the Life Company could go bust and leave the parent company, the reinsurer, in the position of having to honor the claims under the insolvency clause of this contract, plus the fact that although practically on a go-ahead basis, this business generated a very little loss ratio but on run-off if we lost an account, and our experience bore this out time and time again, that loss ratio went right through the ceiling, so that if the reinsurer had ever been put in the position of not—not being able to go ahead on a go-ahead basis, it changed the complexion of this thing entirely.

Q. In testimony by deposition, Mr. Sturtevant, Chief Examiner for the State of Georgia, said that this is not really reinsurance, that it is really an underwriting. Would you [66] comment on that?

A. I don't believe I can, Mr. Harper. I don't understand it, sir.

MR. HARPER: I have no further questions.

THE COURT: All right, Mr. Parks, let me ask this question.

The Government claims that the practical effect of this agreement between these two companies was really no risk of loss to First of Georgia.

A. That's not true, Your Honor.

THE COURT: What was the risk of loss?

A. The risk of loss was certainly less than it was to the primary reinsurer, but a risk did exist, and I have just given you two examples; one. . .

THE COURT: If it just went completely bust.

A. If—say—if they became insolvent. And then if we just, for some reason if we quit writing that business or if we lost our accounts on the run-off, the loss would have been on us.

THE COURT: Yes, I understand.

A. We sued one account trying to get hold of it again.

THE COURT: Of course, they contend that the experience, while on its face it appeared to carry that loss, that risk of loss that you have just mentioned, but that the experience, not only under that agreement, but under similar types of agreements, was that in fact such a loss never does occur. Do you have an opinion as to that?

[67] A. Well sir, that sort of touches on the nature of the insurance business. It's—it's there to protect a company against the unforeseen or the unlikely. Any prudent businessman is going to carry insurance on his plant or his property. Chances are it won't burn down, but he still carries it.

THE COURT: Yes, I think it goes with the nature of the contract of insurance.

A. I do too, sir.

THE COURT: All right, it is their contention that this agreement really does not provide for a bona fide reinsurance. In your opinion, based upon the terms of this agreement and the usage of the trade, is this a bona fide reinsurance agreement?

A. Yes, sir. In every respect.

THE COURT: Is it fair to state that the only reason for it was its beneficial tax consequences?

A. No, sir. That would not be fair at all.

THE COURT: Could this agreement likely have been procured with some third person type of insurance company?

A. Yes, sir.

THE COURT: Is it reasonable to assume that you could have gotten the same type of agreement?

A. Yes, sir. Of course.

THE COURT: All right. Any further questions in the light of my questions?

[68] MR. LUYTIES: No, Your Honor.

MR. HARPER: I have no further questions. We have one witness remaining.

NOTE: The witness withdrew from the stand.

THE COURT: All right. We're going to take just a few minutes recess.

NOTE: Court recessed for ten minutes.

NOTE: Court reconvened after a ten-minute recess.

THE COURT: All right, Mr. Harper, call your next witness.

MR. HARPER: I would like to call Mr. A. C. Eddy.

MR. ARTHUR C. EDDY took the stand, and having been duly sworn, testified as follows:

DIRECT EXAMINATION OF MR. EDDY

BY MR. HARPER:

Q. Would you state your name and present address, Mr. Eddy?

A. I am Arthur Crooks Eddy. I live at 3167 Linden Road, Rocky River, Ohio.

Q. What is your business Mr. Eddy?

A. I am a consulting actuary.

Q. By whom are you employed?

A. I am self-employed.

THE COURT: By whom?

A. I am self-employed.

Q. Do you have any particular qualifications for this, educational or experience-wise?

[69] A. Well, I am a member of the Society of Actuaries by examination. I have been practicing actuarial science for the last 25 years or so, and I have been in consulting business for the last 10 or 11 years.

Q. Have you had any special experience to do with the insurance companies?

A. My entire experience has been with insurance companies.

Q. For over 25 years?

A. Yes, sir.

Q. Mr. Eddy, have you examined the reinsurance agreement that we have here identified and stipulated as Exhibit 12?

A. Yes, I have.

Q. I would like to ask you whether from your experience you find that contract usual—do you find that contract as comparable to what was in effect in the industry generally?

A. Well, in most respects, I think it is quite commonly used by credit life companies in situations similar to the one at hand.

Q. I would like to ask you to explain from your experience the relationship between the accident and health business insurance and the life business.

A. In what respect?

Q. In the way it is written and the way. . .

A. Should I address my remarks to credit insurance?

Q. Yes.

A. Well, the credit life insurance, of course is companion [70] coverage to credit life insurance. They usually go hand in hand in a combined sale.

THE COURT: Say that again.

A. They usually go hand in hand.

THE COURT: What goes hand in hand?

A. The credit life sale with the credit accident.

THE COURT: All right.

A. And generally they are combined in a single policy, but not always. The general approach is quite the same with credit insurance, credit life insurance, as opposed to credit accident and health insurance. There is a substantial difference in the way the two lines of insurance are reserved, as far as statutory reserve requirements. Those differences came about more through historical development of the two lines, individual life insurance and individual accident and health insurance, before the days of credit insurance. This was mostly that life insurance, of course, was developed and evolved through

life insurance companies with their own sets of regulations, insurance, and accident and health lines which evolved through and were introduced by casualty type insurance companies, which have completely separate sets—do have completely separate sets of regulations and codes. The life insurance reserves required for credit life insurance are based on the net risk or the risk insurance and not on the gross premiums, whereas the reserves required for [71] accident and sickness insurance are based on the gross premiums and are in fact the unearned portion at any moment of time of the premium that has already been collected. Now, conceptionally, that's the same as the life insurance reserve on credit life insurance, because at any moment of time, the remaining reserve for life insurance, credit life insurance policy, is the unearned net premium, then unused at that moment of evaluation.

Q. Would you tell the Court the effect of this provisional commission to the agent? It has been testified that 50% of the total premium is actually withheld. Now, in the ceding under this arrangement, what is used; this net premium after the provisional commission or the total premium?

A. Do you mean under the terms of this reinsurance agreement that we are speaking of?

Q. Yes.

A. Well, under the terms of this agreement, the ceding company must cede to the accepting company, the reinsurer, 100% of the premium for the percentage of the risk that the reinsurer is accepting, namely 70% in this case.

Q. Are you familiar with the term "surplus aid contract" as that term appears in the N.A.I.C. Handbook?

A. Yes, I feel I am familiar with that.

Q. Is this a surplus aid contract in your opinion?
[72] A. No, this would be just the reverse of a surplus aid contract in my opinion. See, whereas the basic insurer here, Georgia Life, I believe you refer to it as, insures a risk, let's say, for a dollar premium—accident and sickness premium. It immediately pays a commission to the agent of fifty cents, receiving a net sum of

fifty cents which goes into the assets of Georgia Life. When Georgia Life reinsures this risk under the terms of this agreement, or did reinsure this risk or 70% of this risk under this, what was to have been a reinsurance agreement, it was compelled to pass on to Georgia Insurance seventy cents out of the original dollar, or representing the original dollar, which on the surface would appear to have caused a surplus drain to Georgia Life, because they did not receive a commission credit or a front end commission or earned commission—I mean commission credit.

Q. So on the surface, this is really a surplus drain which is actually the opposite. . .

A. Right. . .

Q. . . . even though minor. Was it major or minor?

THE COURT: Well, let me ask you this. Suppose they had kept that instead of reinsuring, what would have been the effect upon its surplus then?

A. I would like to make that illustration comparative. First of all, suppose for the moment, to make it easier for me to [73] relate, that the main insurance quota was 100%, just for simplicity. Had there been no reinsurance, Georgia Life would have at the moment of sale shown a loss of 50 cents, because they would have had a dollar. With the reinsurance agreement as it was worded, the Georgia Life continued to have precisely a 50 cents loss, because it had received 50 cents. It had for that 50 cents been required to set up a reserve of a dollar, but it passed on both the fifty cents and the dollar to the reinsurer.

THE COURT: All right. It's a negative type of benefit then, from the standpoint of the reserve it must keep.

A. Well, we consider it a zero benefit from the reserve it has to keep. I mean the net effect of this transaction is zero on the books of Georgia Life. May I repeat the example?

THE COURT: Repeat it.

A. Had there been no reinsurance, Georgia Life would have received a premium of a dollar, paid a commission of fifty cents, set up a reserve of a dollar. The

net result is a loss of fifty cents. With the reinsurance, Georgia Life received a dollar, paid fifty cents in commission, remitted a dollar in reinsurance premium, but the reinsurance company simultaneously put up a dollar liability.

THE COURT: All right. All right. Well, how does it put it in a better position to expand its business than if it hadn't done all that?

[74] A. Well, there are two ways that that occurs with respect to this particular operation, in my opinion. The first has to do with the argument that the company should write a respectable amount of new premiums in relation to its capitalization. Now, what that ratio should be is subjective matter, and I don't propose to say, but obviously you wouldn't expect a company to write \$10,000,000 of premium income with \$1,000.00 of capital and surplus so there is some ratio which would be unacceptable. That ratio is very simply the premiums written divided by capital. Now, if it is to the advantage of a company to minimize that ratio, that is to keep premiums small in relation to capital, then it is to the advantage of any such company to rid itself or rather never write accident and health insurance, and—as a life insurance company, or if it writes such insurance, to rid itself of that insurance. It's better not to write it for this reason. If the premium is all life insurance, there is an immediate statutory gain on the sale of a life insurance policy, a small percentage of the premium. For the sake of this example, let's say 10%. So the premium divided by the surplus, which was before the sale, is a larger ratio than the premium divided by the surplus plus the increase in profits as a result of the sale.

THE COURT: Say that again, please.

A. Supposing as an illustration, the surplus had been a dollar, [75] and we write a dollar's premium, and the profit level should be about 20 cents immediately on a life sale. So if we wrote a dollar premium, we would be dividing it by a dollar twenty; namely the dollar surplus to commence with plus the twenty cents gain we had realized from the dollar premium. So that ratio

then is one over twelve or about $83\frac{1}{3}\%$. If we wrote accident and health insurance on the other hand, we have just gone through the illustration, and we know we have a fifty cents loss, so if we wrote \$1.00 of accident and health insurance, it would be divided by a dollar of surplus minus a fifty cents loss or a ratio of 200%. So if you are faced with that problem, and it is more a matter of image in my opinion than financial necessity; yet the Insurance Department deals very much with images, and customers deal very much with images also. If a company had been forced to be concerned about its image, it would then make all efforts to reduce that ratio. This reinsurance agreement accomplished that, because it allowed Georgia Life to show, in the example I just gave, a zero premium with a 50 cent remaining surplus, which is a ratio of zero. Obviously, that is not as favorable an arrangement as they should have and could have made in my opinion, and that's wherein this treaty differs, I think, from the usual treaty that reinsurance companies employ, and certainly where this treaty differs from a surplus aid or surplus relief agreement, and because [76] in Georgia's case, they continued to bear the fifty cent loss on the sale of a dollar premium, whereas it was very customary and generally in practice for companies to receive the fifty cents commission from the reinsurer immediately on paying the fifty cent commission to the agent. In that case, Georgia Life would have been fifty cents better off with reinsurance than without, but it would have been in no better position than if it hadn't written the business at all. Now. . .

Q. No better surplus position?

A. No better surplus position. Obviously, they would have been in a better position in the long range if it stood to gain something from the business itself, which I believe is the case here. Now, if a company had been interested in, say, the tax advantages—that should be their motivation—they would have been stupid to have taken the approach in my opinion that Georgia Life did. I mean if that had been their sole purpose, because the taxes—the insurance company is taxed on its gain from operations at the standard normal tax—corporate tax

rate, but only half of the income is exposed to the tax rate. Now, if Georgia Life wanted to keep the fifty cent commission, that was an insurance gain from which it would only receive half credit in its taxable income, so to speak. If it had passed the fifty cent burden on to the reinsurer, the [77] reinsurer would have been deducting the fifty percent commission at the full corporate rate, or if you would, would have paid half as much taxes as a result of the fifty cents commission. I have kind of wandered so far I don't know what the question was any more. Have I answered it?

Q. I think you have answered the question. There has been noted in the previous testimony that there was no provisional ceding of the commission from the parent reinsurer to the primary reinsurer. Would you comment upon that specifically as it affects this instrument?

A. I am sorry. Would you please repeat the question?

Q. It has been—I will word it another way—it has been testified that the commission was transferred from the reinsuring company down to the primary company only on an as-earned basis.

A. Yes, sir.

Q. Now, it was further testified that there was no provisional ceding of that commission. It was only paid as earned. What effect did that have that they had no provisional ceding?

A. Well, I think I have properly spoken on that point.

THE COURT: He just, I think, answered it. I didn't follow it completely, but I think he tried to answer that precise question, didn't he?

A. Yes, sir.

[78] Q. And that's the essential element, that provision which is missing here, is the essential element of a surplus aid contract.

A. That is certainly one of two elements that are specifically mentioned in the N.A.I.C. Guidelines, which are what they say—guidelines. The other being that it is a guaranteed profit.

Q. Is this a guaranteed profit contract?

A. In my opinion, it is not a guaranteed—to be guaranteed, you have to guarantee that you would never have a loss over a certain amount, which is an impossibility. Your Honor, I mentioned just a moment ago that there were two arguments, and I failed to mention one. May I go back and finish it?

THE COURT: Certainly.

A. The other advantage of reinsuring, either the credit life or the credit accident and health, but because of the complex or combined reasons, more of the advantage in this case to credit accident and health than not reinsuring is the increasing of the number of insured. Several witnesses before were speaking of this point, but. . .

THE COURT: You get a better base. Is that the terminology?

A. The base is the number of people. You have only got 30% of each guy under this arrangement, but that allows you to have $3\frac{1}{3}$ guys for the same dollar, which is what we work with in the insurance business or the laws of averages, and [79] they don't—they don't hold as well with small numbers as with larger ones.

Q. Under the reinsurance agreement, Exhibit 12, as amended, who was at risk for the insurance losses—the losses or indemnity under the policy?

A. You mean on the 70% which had been reinsured?

Q. On the 70% which had been reinsured.

A. Well as I understand it and see it, once the policy was sold and 70% of the risk reinsured with Georgia Insurance, Georgia Insurance became liable for the claims at least to the extent of the premium that we had—that had been passed on to them by the ceding company; so they were also in my opinion liable for any loss of any amount, but unquestionably they held the money for seventy cents, and they were obligated by the treaty, unless they were insolvent, to reimburse their agent in effect, to Georgia Life, who had paid off the policy holder. I say it was Georgia Insurance who was liable under this agreement for 70% of the risk that they took.

Q. Then you feel that it is not accurate to say that there was no risk on the reinsurance company?

A. No, not any more than to say there is no risk on the issuing company. To say that the reinsuring company didn't have to pay its 70% of the claims because it had no risk to me is the same as saying the insurance company doesn't have [80] to pay their claimant at all.

Q. By deposition, the Chief Examiner, State of Georgia Insurance Department, indicated that he felt that this was an underwriting, not a sharing of the risk. Would you describe—would you differentiate the term “underwriting” or “sharing of risk”. Is there any—in the insurance field, does the terminology strike you as meaning anything?

A. Well, the word “underwriting” I don't understand as applied to this particular arrangement and its application to insurance. I don't understand it's meaning here in that statement.

MR. LUYTIES: Your Honor, this deposition hasn't been offered into evidence at this time. What portion is counsel referring to?

MR. HARPER: I think maybe we ought to stop at this point and get these depositions in.

THE COURT: Well that's the only phase that he's really talked about, and he hasn't been able to get a positive answer yet, so it doesn't make any difference.

But anyhow, in reference to what he said, as a lay person I would consider the two terms to mean the same thing. After all, the reinsurer here, in the event the primary insurer went broke, in a sense guaranteed the payment of that policy to the policyholder. Now, if he underwrote it, what's the difference—as a lay person, I would assume that the term underwriting would mean the same thing. That if primary went broke that the reinsurer had to pay it.

[81] MR. LUYTIES: Well, that is what I am trying to find out. I am not sure that our examiner referred to it in the same context. Perhaps so.

THE COURT: Well there may be a refined meaning of the term that I don't know, but that is what I would understand.

CROSS EXAMINATION OF MR. EDDY

BY MR. LUYTIES:

Q. Mr. Eddy, do you have a copy of the Examiner's Handbook before you, sir?

A. No, I don't.

NOTE: The witness was given a copy of the handbook.

Q. Mr. Eddy, would you refer to pages B 14 and B 15 with reference to the discussion of guaranteed profit contracts?

A. Well, if this is the Government's xerox, some of the wording is not too clear. I am on page B 14. What do you want me to do?

Q. Just refer to the guaranteed contract profit section at the bottom of page B14—that paragraph—and it continues on to the top of page B 15, and there is another paragraph after that which I would like to refer to specifically. The last three sentences read "to this extent there may be a slight element of risk-taking on the part of reinsurer. If the loss ratio ran over 100%, the reinsurer would then [82] become liable for such losses. This is a remote possibility and it is largely of academic interest." You are familiar with that portion of it, I take it?

A. As of this moment, sure.

Q. Even under a guaranteed profit contract then as described in the handbook, there apparently is some remote risk as they say that the reinsurer could incur an ultimate loss, is that correct?

A. To take their words literally and the way I take them, yes.

Q. Okay, well aren't they saying in effect, and have you seen the following example where they use the tentative commission, a fee, and then the rest is going to go to the primary writer depending on loss experience.

A. Yes, I have been through this with some of your associates.

Q. Okay. Aren't they saying in that event that even though there is a 3% or 4% or 5% fee and that all the

losses will be deducted to the 96 or 97% of the earned premiums in excess of that fee, aren't they saying that there is still a possibility of risk of loss to the reinsurer if the loss ratio exceeds 96 or 97% of earned premiums?

A. Precisely and the same as any other reinsurance agreement in that regard.

Q. Right. So the fact that this agreement that we have in this case doesn't say guaranteed but does refer to a constant fee is not critical as far as its characterization [83] as a guaranteed profit contract or not, is it?

A. That doesn't make it critical. That doesn't define it as a guaranteed profit contract.

Q. So in fact if we had a tentative commission of, let's say, 45%, a provisional ceding commission has also been referred to in our case, wouldn't we in effect have a guaranteed profit contract?

A. Well, none under the terms of this agreement we are speaking of, because under the terms of this agreement, there was the provision for a loss in excess of the premium paid to the reinsurer.

Q. That's true, but isn't this what they are also talking about in the handbook?

A. I think maybe we should at least bring out that this handbook and this section of this handbook is written specifically with reference to fire and casualty companies.

THE COURT: To what?

A. Fire and casualty insurance companies, and we are really speaking about life insurance companies.

Q. But we are talking about reinsuring accident and health, are we not?

A. As part of a life insurance company's operation.

Q. Yes, but is there a material difference between reinsuring accident and health or credit accident and health and reinsuring fire and casualty?

[84] A. I would think yes. There would be considerable difference between them.

Q. Okay, well, how does it affect it as far as characterizing a given agreement as a guaranteed profit contract or not?

A. Well, because the probabilities are more predictable than non-human factors—the burning of a building. It is more accurately predictable than the occurrence of a disability, and particularly in the last decade or so in credit accident and health insurance where the trend has been from very short term loans—90-day loans—now frequently you run into a 5 year contracts with A & H coverage.

Q. Going back through the years 1961 through '64, are you saying that the expected loss ratio in credit accident and health would be greater than that in fire and casualty and therefore these provisions, talking about guaranteed profit contracts, might not be applicable?

A. I wouldn't say that they were necessarily greater or larger, but that the actual result related to expectations that you put into your premium are much closer in the fire and casualty business and historically have always been.

Q. Historically, and going back again to the years of the suit, '61 through '64, weren't the loss ratios in credit accident and health low, in the 20 percent, 30 percent bracket?

A. They vary pretty much. But during that period of time, I think around a 30 to 31 cent loss ratio would have been [85] more common than credit accident and sickness.

THE COURT: Let me ask you, did this agreement provide for tentative commission or. . .

MR. LUYTIES: No, sir.

THE COURT: Well, then that would take it out of what you are talking about here.

MR. LUYTIES: As far as the provisional commission, yes. . .

THE COURT: Well, I think that is an important ingredient of it, isn't it?

Q. As far as characterization as a guaranteed profit contract, is that is the critical part?

A. Well, can I refer back to page 14 in the opening sentence? It says "the most common form of surplus aid is the guaranteed profit contract, and its principal characteristic is that it transfers unearned premium reserve

from the ceding company to the reinsurer and results in an immediate increase in the ceding company's surplus." Well, that would seem to rule this one out completely, because this is anti or the reverse of surplus relief contracts.

Q. Right. It seems to me that by the term guaranteed profit, what they are interested in also is a guaranteed profit to the reinsurer. Is not that true?

A. Well, I guess I can't speak any further on that subject, because it seems that it is barred by that language.

Q. Okay. In a guaranteed profit contract, however, would the [86] risk of loss remain with the primary writer?

A. Well, I am not sure that I understand your question right, but I will take a shot at it. The primary loss or 70% of a risk—of a claim—was with the reinsurer. 30% of the risk of loss was with the primary insurer.

Q. Well, assuming that it was a guaranteed profit contract and. . .

MR. HARPER: Your Honor, I object to his considering that it's a guaranteed profit contract when it's very clear here that it is not.

THE COURT: Well he has him under cross examination, Mr. Harper, I will allow the question.

Q. Mr. Eddy, let's assume that we have a guaranteed profit contract, and we are just talking about the rein—the insurance purported to be reinsured. On the reinsured portion of the business, who bears the risk of loss?

A. Would—I have to repeat my answer, although maybe I can give you a different answer if you will define for me what you mean by guaranteed profit contract?

Q. This example right here is what I referred to.

A. Just half of this example. . .

Q. Pardon?

A. This whole example, or just half of this example?

Q. This example with the added assumption that we are talking about, the reinsured portion of the business.

THE COURT: By this example, you mean the one contained in [87] the examiner's handbook?

Q. Exactly. 45% tentative commission, 3% ceded to the insurer,—where there is a remote possibility, one largely of academic interest, that the reinsurer will become liable for such losses if the loss ratio ran over 100%. Now given that hypothetical situation, who bears the risk of loss on the insurance reinsured?

A. The man that's got the money, and that's the reinsurer.

Q. Let's exclude the possibility that—the remote possibility that there could be a loss in excess of 100%. Barring that possibility, who bears the risk of loss on the business reinsured?

A. No matter what percentage loss you say, the man that's got the money pays the claim.

Q. Well, Mr. Eddy, you referred to your previous testimony in court, is that correct?

A. Did I, you say?

Q. Yes, you referred to previously testifying on such matters.

A. I don't believe I said that.

Q. Did you testify in the ITT Hamilton Life Insurance Company case?

A. I did.

Q. Before Commissioner Fletcher in the Court of Claims?

A. Yes.

Q. I have a copy of that transcript, and unfortunately this I [88] have not xeroxed. I will present it to you, however, and I will tell you that at this part you were discussing the guaranteed profit contract. I would like you to read this page 122.

A. What page?

Q. Just that one page, 122.

NOTE: Pause while witness reads page.

Q. Do you recall the testimony at that time?

A. I do generally, yes.

Q. The question was, and they are referring to guaranteed profit contracts, "Now except for this remote possibility of losses exceeding total premiums that you referred to when you discussed it before, who has the

risk of loss?" Answer—"Barring that risk, then you have to assume that the ceding company has the risk." Question—"The ceding company"? Answer—"Yes". Question—"Not only assume it it does have the risk, doesn't it?" Answer—"Barring the possibility, yes." Did you make the statements at that time.

A. I take it I did, since you have the transcript there. I don't think we have it in the same context however, and I think that in order to do that it would be necessary for me to read that entire section. And in order—in the first place ITT Hamilton was in a somewhat different role, although the problem was the same.

[89] Q. All right, Mr. Eddy, I understand that. And you can refer to this entire transcript. I would suggest you refer from page 117 approximately to 122.

A. How about from page 1.

Q. If you have the time, but I don't think the Court can—I just want you to make sure that you were talking about a guaranteed profit contract.

A. In the first place I will just say this. In those—the ITT Hamilton case these companies were not in the same position. In the first place, the answer to this, in regard—the same question in regard to different positions might be different. I am not saying that it is. Secondly even in the ITT Hamilton case, I do remember that my position was that there wasn't the guaranteed profitability involved, because there was always the remote possibility that there was a contingency that would occur.

Q. All right, well we are not talking about the facts of ITT Hamilton, in my hypothetical, but we are thinking about the guaranteed profit contract exemplified by the Commissioner's Handbook, and you were discussing guaranteed profit contracts in general at that stage of the proceedings, were you not?

A. Well, those questions were being asked at that stage of the proceeding.

Q. Okay, so my question is then what is your opinion, as it was then that the ceding company retains the risk of loss in [90] a guaranteed profit contract, or now that the reinsurer maintains the risk of loss in such an arrangement.

A. Well, my position is the same, and I believe it is consistent in both cases. The man with the money has to pay the claim. Now, if it's the ceding company, obviously the relationship between the policyholder and the ceding company is by contract between those two parties, and the ceding company is certainly liable to pay the claim, but there is a second contract, and the second contract reimburses the ceding company for the loss, and I have to say that I believe the accepting company, the reinsurer, is the ultimate bearer of the risk to the extent of his liability, and if he has the premium, then it works that way in practice as well.

Q. Regardless of who bears the risk of loss then, you are saying, it is the insurance company that has the unearned premium, the asset account, is that correct?

A. The one that has the money pays the claim.

Q. Yes. Regardless of where the risk of loss lies, is that correct?

A. Well, presumably the—only the man who has the risk has the money.

Q. But if this doesn't happen, still you look for where the money is and not to where the risk. . .

A. I don't know how that happens. In practice, I am not aware [91] of that.

Q. Okay, let's assume that we are in a State where a reinsurer is not authorized to do business, that the ceding company enters into a reinsurance agreement with that unauthorized reinsurer, that the reinsurer maintains an unearned premium reserve on the insured business. Who—is the ceding company entitled to a credit for the reinsurance, for the unearned premium reserve maintained by the reinsurer in that instance?

A. Now, that is a new question.

Q. That's right.

A. That's not the question about who has the risk. You are asking who is holding the reserve.

Q. Pardon?

A. You are asking who is holding the reserve.

Q. My question is, in that situation, is the ceding company entitled to a credit for the unearned premium reserve maintained by the reinsured?

A. In the case that you cite, there are more than one possibilities.

Q. Can you give me a yes or no answer?

A. Not without enumerating the possibilities. I can give you yes or no to each possibility. For example, when there is an unlicensed or an unqualified reinsurer involved, one arrangement is to have what they call modified co-insurance or modified reinsurance whereby the ceding company holds [92] the money, and the reinsurer simply stands behind the risk and pays in the event that the claims go beyond the expectation.

Q. Well, this . . .

A. Now, there is also the possibility that the reinsurer, not qualified, receives the money from the ceding company, in which event the reinsurer, non-qualified as he may be, would be obligated to establish a reserve, but so would the ceding company because of the non-qualification.

Q. So in that case where the reinsurer gets the money, gets the premium, the unearned premium, the asset, the ceding company is not entitled to a credit for the reserve maintained by the reinsurer, is that correct?

A. In that example. That possibility.

Q. What is the basic purpose of reinsurance, Mr. Eddy?

A. The basic purpose is really to spread the fluctuation in a company's earnings.

Q. To sort of level out your claim's experience, is that right?

A. To level out your experience in all of the expectations, depending on what you are reinsuring.

Q. All right. In this situation in the reinsurance agreement in dispute between Georgia Credit Life and Georgia Insurance whereby the return of Georgia Credit Life was directly dependent on its loss experience up to 96% of earned premiums, where therefore its profits fluctuated directly [93] dollar for dollar with the loss experience, how did this agreement further the basic function of reinsurance to level out your claim experience?

A. Well, I didn't concede that this treaty was for that purpose. This treaty was for the purposes already discussed.

Q. So this treaty didn't further the basic purpose of reinsurance to spread risk, is that what you are saying?

A. No. No, no. I don't want to answer that question. Now, wait, I don't say that the only basic purpose of reinsurance is to spread the risk or the loss.

Q. But you are . . .

A. There are many reasons for reinsurance, some of which we have heard discussed here today, other than spreading of risk.

Q. But you . . .

A. But there was a spreading of the risks involved in this treaty which I alluded to earlier when I said that they could take more lives.

Q. Excuse me, but to that extent, this agreement did not further one basic purpose you just testified to, i.e. spreading of risk and leveling claims, is that correct?

A. I still refuse to answer it that way. If you are going to say . . .

Q. I asked you a question. You are not going to answer it, is that correct?

A. Excuse me, I don't mean to be rude and impertinent. I am just saying that by using the word "basic", we may have misnamed or [94] misclassified what I am trying to say or respond to. "Basic" to me means the usual, normal, ordinary or customary. It's not the fundamental or the only basis. In my way of thinking, if this had been a reinsurance treaty of airplane hull coverages, then we are talking about spreading risks, but this is a reinsurance treaty of credit A & H which was for other reasons than trying to spread the risk, although I will agree that your usual basis or purposes of reinsurance are spreading one of more or four risks, only one of which is the probability of death or disability or fire or whatever we are speaking of.

Q. Thank you. I have no further questions.

THE COURT: Well, is it your testimony then that one of the primary reasons for this or primary benefits of this agreement was that it did permit the primary insurance company to write three times as many policies, that is to increase its base?

A. I believe that is a logical conclusion, yes sir.

REDIRECT EXAMINATION OF MR. EDDY

BY MR. HARPER:

Q. Are you familiar with the Georgia statute on reinsurance from experience in Georgia?

A. Yes, to the extent of . . .

Q. Would you say that this treaty meets the Georgia Statute [95] as to reinsurance?

A. Yes, I believe it does.

THE COURT: Which statute is that?

Q. It is cited in the pre-trial, 56-413. I have no further questions.

THE COURT: Any further questions? All right, you may go down.

NOTE: The witness withdrew from the stand.

NOTE: COURT RECESSED FOR LUNCH.

NOTE: COURT RECONVENED AT 2:00 P.M.

MR. HARPER: Your Honor, before resting here, I would like to clarify the status of the record insofar as these depositions. In that connection, and I believe it is already a part of the Court Record, I would like to offer the deposition of Lawrence Earls, a resident of Atlanta, Georgia, beyond the territorial limits of this Court. If it pleases the Court, I would like to offer that in evidence.

THE COURT: Which one is it?

MR. HARPER: That is the deposition of Lawrence Earls who is the Chief Examiner for the State of Georgia for the years in question. He wasn't Chief Examiner; he was Senior Examiner.

THE COURT: Well, you mean the whole deposition?

MR. HARPER: Yes, sir.

THE COURT: Well, you read it then. You read it into evidence. What purpose? Why do you want to offer it?

MR. HARPER: It covers two important matters. First, the [96] testimony develops the difference between the audit emphasis in accounting generally from the audit

procedures and emphasis for the regulatory body, that is not developed in testimony so far. From the standpoint of income tax accounting, we will take here and in all cases like this a going concern presumption. We will look at it in a different light than the Examiner does when he goes through it with regulatory agents. It is clear from this that as an Examiner from the State of Georgia, he took a dim view . . .

THE COURT: He did what?

MR. HARPER: He took the—he took the view of what would happen in the event of liquidation.

THE COURT: Now, Mr. Harper, why do you want to prove their case?

MR. HARPER: Well, I don't—I want to emphasize that the audit has been different—that these—the audit we have here would reflect certain things that would not be binding upon this court, because—and not even a guide to this Court, because income tax would have . . .

THE COURT: Well, how is it in here to guide me to start with?

MR. HARPER: Well, it's probably not, but when I rest, I am assuming that the witness to follow that they have an examiner who examined and did the same work in later years.

THE COURT: Well, why don't you wait and see if that actually happens. You know, I don't want to have to read an [97] 80-page deposition unless I really have to.

MR. HARPER: I do not blame you, but in resting, I did not want to lose the right. Once that is clarified, I'll be . . .

THE COURT: Well, you can use it by way of rebuttal or some other way if you find it necessary, but so far, I don't know why you would want to put this in.

MR. HARPER: Well, the second point is that it shows that he did check this reinsurance agreement. He found it valid under the laws of Georgia and approved it.

THE COURT: All right.

MR. HARPER: The Plaintiff rests.

THE COURT: Does the fact that the State Examiner approved the agreement have any significance, any tax significance?

MR. HARPER: Your Honor, I think really not, but I could not help—sometimes the Courts of Appeal, you know, find something important that I don't. I believe the Supreme Court has made it clear from some cases that State Law is not—that State procedures don't guide.

THE COURT: Well, I think they have conceded this, that the reinsuring agreement did meet the law of Georgia.

MR. LUYTIES: No, we are not conceding that, Your Honor.

THE COURT: Why not? I thought you did.

MR. LUYTIES: There was no Georgia law in that regard. As a [98] matter of fact, there was just a general provision in the Code 56-413 that recognized the reinsuring of risks. This, of course, assumes that risks are reinsured.

THE COURT: Well, didn't the State approve this agreement?

MR. LUYTIES: It did not disapprove it. In a later year, it disapproved it, so we don't . . .

THE COURT: You mean, when, sometime beyond the maturity?

MR. LUYTIES: That's correct. In 1969, as a matter of fact, it did disapprove it. Our position is that Georgia Law was not controlling one way or another on this point.

THE COURT: Well, I am inclined to agree with you. I don't think it has any great significance. Of course, again I have to assume that it's object is to protect the policyholder.

MR. A. C. EDDY took the stand, and having been previously sworn, testified as follows:

EXAMINATION OF MR. EDDY

BY THE COURT:

Q. Do you know of any reinsurance agreement which is—you would characterize as a standard one in the trade or in this business which does not somehow pro-

vide for—well, I use the term “recoupment”—of a loss which may be sustained by the reinsurer?

A. If I understand you, do I know of a reinsurance treaty in common use which does not provide for recovery of a loss [99] by the reinsurer?

Q. In some way?

A. Yes, there are such treaties. Reinsurance generally falls into two categories. One which is referred to as—various names—but the word nonparticipating, meaning that it is a guaranteed premium and the reinsurer takes the risk at that premium, and then whatever happens, it pays for the claims for the risk it took.

Q. Do those two things generally go hand in hand, that is a guaranteed, as opposed to one that is not reimbursed if there is a law?

A. Well, that is on the guaranteed side now. And that is called nonparticipating. Also just as common, in fact probably more common, is a participating reinsurance contract which is conceptionally the same as we have here, that is the reinsurer agrees to go into the risk, and this is for any kind of life insurance or accident and health insurance and not necessarily credit. He agrees to accept the risk for a specified premium and then to take off the top 6%, 10% for expenses, and to share any balance between what is left and the claims paid with the insuring company. If, however, the claims exceed what is left, then the reinsurer pays the claim but carries forward the loss or the excess to a subsequent year. Now, that is a very similar conception to the contract we have here, and that, I would say, is [100] probably the most common.

Q. Now, in your opinion, does this contract or this treaty, as you call it, between the two companies here, the parent and the subsidiary, is it a bona fide reinsurance agreement?

A. In my opinion, it is, because I have seen so many of them and it is I think very common. The only thing uncommon . . .

Q. Well, aside from having seen it so often, but in your opinion, is it a bona fide reinsuring agreement?

A. Yes, sir, in my opinion.

Q. Now, explain to me again—I thought I caught it—but why this reinsuring in this particular instance made it possible for the credit life insurance company to write three times as much insurance as it might have without the reinsuring.

A. Take for the moment that we are speaking of only credit accident and sickness insurance just for the argument, because that is all that is reinsured here. If they could only write \$1.00 premium, because their surplus position and that ratio of premiums written to their capitalization was so critical that they were only permitted to write \$1.00 for image purposes or any other purpose, then if they took just one policy, 100% of one policy, their chances of enjoying the law of averages are greatly reduced as compared to their taking 30% of $3\frac{1}{3}$ policies, which would result in exactly the same position.

[101] **THE COURT:** Any questions either one of you want to ask in view of my questions. All right, you may go down.

NOTE: The witness withdrew from the stand.

MR. LUYTIES: Your Honor, before I introduce the first witness I would like to make sure that we have all the exhibits into evidence that we are going to put into evidence. We mentioned several in the pre-trial order that have not been introduced so far that have been agreed to. At this time, I would like to introduce into evidence selected minutes of the First of Georgia Credit Life Company's Board of Directors meetings.

MR. HARPER: I would like to limit it to those that are pertinent to the proceeding and have some reference to them as to what they think is pertinent. I've seen them, and I see no relationship, and I think it just burdens the record unless there is some understood issue raised by these.

THE COURT: Well, I will ask him what he contends they show.

MR. LUYTIES: These are introduced merely for the purposes of showing the fact that dividends were often considered and declared and paid and the inference that

can be drawn from this insofar as concern for the surplus position of the Credit Life Company.

THE COURT: Well, my recollection is, I believe, Mr. Phillips testified to the various dividends, \$60,000, 1959, [102] \$31.5, 1960 and \$30 in '62 or '63.

MR. LUYTIES: That's correct.

THE COURT: Is that all you want to show by that?

MR. LUYTIES: Well, they were considered more than that in the extent of the discussion in regard to them and the fact that they weren't concerned about surplus as far as these minutes show.

THE COURT: Don't put in here, you know, just reading material. I think you have already stated the purpose of it. Now, is there anything more than that?

MR. LUYTIES: Well, as opposed to the handbook, I certainly would be selective in stating the portions that are relevant, and we have a huge stipulation of exhibits, as you know, and I don't—these are admitted but, of course . . .

THE COURT: As I understand it, the purpose of them is to show, number one, that they weren't worried about surplus, and that they obviously weren't or they wouldn't be paying these dividends.

MR. LUYTIES: Right.

MR. HARPER: I am familiar with those minutes. I do admit they considered it, but that doesn't mean they aren't worried about surplus because you've considered dividends. This is particularly true in the insurance field, because dividends from certain sources were non-taxable up to [103] a certain point, absolutely. Now, you have an inter-company dividend credit, but no insurance companies, there's even a greater amount when it comes from certain sources.

THE COURT: All right, sir. I will admit them for what they are worth. Does that satisfy you?

MR. HARPER: Yes, sir.

THE COURT: Mr. Harper, any objections?

MR. HARPER: No objections.

MR. LUYTIES: At this time, the Government would like to call Mr. Bobby Clark.

MR. BOBBY S. CLARK, after being duly sworn, took the stand and testified as follows:

DIRECT EXAMINATION OF MR. CLARK

BY MR. LUYTIES:

Q. Mr. Clark, please state your full name and give us your residence address.

A. Bobby Steed Clark, and I reside at Rt. 3, Box 2, Hopkins, South Carolina.

Q. And you come today pursuant to a subpoena?

A. I have.

Q. What is your present position?

A. I am a Senior Examiner with the Georgia Department of Insurance.

Q. Is that your only employment at the present time?

A. Yes, sir, it is.

[104] Q. How long have you been a senior examiner with the State of Georgia Insurance Department?

A. Somewhat over five years, sir.

THE COURT: You mean they don't require you to live in the State . . .

A. No, sir.

THE COURT: . . . when you work for them?

A. May I address the Court, sir?

THE COURT: Certainly.

A. We, in doing the financial statements on the various companies must go to the home office, and it really is of little consequence where you live, because you are never there.

THE COURT: I will understand that. I have the same problem at times in this district.

Q. How long have you been an insurance examiner in total, Mr. Clark?

A. Approximately 12 years, sir.

Q. What kind of educational background do you have?

A. I hold a B.S. Degree from the University of South Carolina as an accounting major.

Q. How many examinations of insurance companies have you conducted during the time which you have been functioning in this capacity?

A. I have participated in or either conducted entirely approximately a hundred and twenty examinations in this period. [105] Now, I would like to qualify that and state that some of these were small county mutuals which only required from two days to maybe a week in duration, and the others would be of an average length of time.

Q. What is the average length of time?

A. Well, not including the multi-billion dollar companies which you have which take approximately eighteen months to twenty-two months, I would say three to six months.

Q. Have you examined credit accident and health and/or credit life insurance companies?

A. I have.

Q. How long does such an examination take ordinarily?

A. Well, that would depend, sir, on the size of the company. I would say probably three months on the company in question—on the entire group.

THE COURT: On the entire group?

A. Well, there were three companies in the group, sir.

THE COURT: These three companies?

A. Yes, sir.

THE COURT: I see.

Q. You are saying this examination, examination of First of Georgia Credit Life and the two other companies would have taken three months. How many credit accident and health insurance companies all together have you examined?

[106] A. I took stock this morning, and I counted around a dozen—pure credit life and credit A & H companies. Now, of course, I have examined other companies that handled that particular line.

Q. During the course of those examinations, Mr. Clark, have you noticed the percentages of incurred losses to premiums earned?

A. That again, sir, would depend entirely upon the underwriting practices of the company and to whether

or not it was captive business. A desirable ratio, I would think, would be . . .

Q. That is not my question, Mr. Clark. I am saying first of all have, you just observed the relationship between losses and earned premiums among the accident and health insurance companies?

A. I don't think I can give you an accurate answer, other than in general terms, I should think that the loss ratios would normally be low.

Q. Well, that's my next—he answered perhaps my next question. What is the typical loss ratio in a credit accident and health insurance company, as far as your examinations go?

A. I haven't made a study of this or plotted it. I would say that twenty or twenty-two percent would be a desirable pure loss ratio.

Q. Aren't those in fact . . .

[107] THE COURT: Not to exceed that? Not to exceed that?

A. Yes, sir.

Q. Have you observed that to be the case?

A. I can't state with absolute certainty that I have ever observed it in any particular company at this point.

Q. Have you ever observed a company which had incurred losses in excess of 96% of earned premiums?

A. Pure losses?

Q. Yes, sir.

A. On credit life and A & H? Not that I can recall.

Q. How about just strictly for credit A & H, accident and health?

A. Not pure losses, no, sir.

Q. Then we are referring to benefits only, is that correct?

A. Right.

Q. Are you familiar—have you during the course of your examinations analyzed reinsurance agreements?

A. Well, of course, that is a part of each examination, and we are required to not only read the contracts, but to see what effect it would have on the financial position of each company in order to establish the li-

abilities, both pure and contingent, and this would be an ordinary function during the examination.

Q. Are you familiar with the reinsurance agreement effective December 31, 1961, between First of Georgia Credit Life [108] Company and First of Georgia Life—First of Georgia Insurance Company?

A. I am familiar with agreement that was dated . . .

Q. You are familiar with that?

A. I am familiar with agreement—an agreement, rather.

Q. Let me present you with a copy of that.

THE COURT: Well, show him a copy of what has been admitted into evidence. Isn't that plaintiff's 12? Plaintiff's 12.

Q. I have handed you a copy of that reinsurance agreement, Mr. Clark.

A. This appears to be the same one.

Q. The one that you are familiar with?

A. Yes.

Q. Now, Mr. Clark, I will state to you as a fact that Georgia Insurance, the reinsurer under this agreement, maintained an unearned premium reserve equal to the portion of the liability it assumed by the terms of that agreement. That would have been 60% in 1961, 70% in 1962, 3 and 4. I will also state as a fact that Georgia Credit Life deducted the unearned premium reserves, thus taking a credit for the reserve maintained by Georgia Insurance. On the basis of your experience as an Examiner, on the basis of your examination of other credit accident and health insurance [109] companies, and on the basis of the agreement before you, do you have an opinion as to whether or not Georgia Credit Life should get the credit for the unearned premium reserves maintained by Georgia Insurance under that agreement?

A. Under the terms of this agreement. . .

MR. HARPER: I object to this, in that it is not responsive to the particular period of time. The work done—I don't think he clarified what years he worked on them. The circumstances, I think the facts will disclose, that this examination took place at a time after

this company had been sold, new insurance agreements in effect, both parent and subsidiary had been sold. Conditions were completely changed. I don't see that the testimony here is germane to the issue here before the Court.

THE COURT: I will rule against it. Proceed.

Q. First of all, Mr. Clark, do you have an opinion as to the correctness of the credit claimed by Georgia Credit Life?

A. In my judgment, this con. . .

Q. Mr. Clark, could you just answer yes or no and then we will explain. . .

A. Could you state the question again, please?

Q. Right. Given the agreement and the experience that you have, your observations in making examinations of credit A & H companies, and the facts that Georgia Insurance maintained an unearned premium reserve and that Georgia Credit Life [110] took a credit for that unearned premium reserve, do you have an opinion as to the correctness of Georgia Credit Life's deduction?

A. The deduction should not have been made under the terms of this contract.

Q. What is the basis for your opinion, Mr. Clark?

A. This contract does not meet the requirements, in my judgment, of the stipulations set forth by N.A.I.C. for this type contract and, consequently, credit for unearned premium reserves would not be allowed. Generally. . .

Q. Excuse me. Do you have a copy of the N.A.I.C. handbook?

A. I have one in my briefbag.

Q. Let me give you my copy. Please refer to pages B-14 through 16. Mr. Clark, are you relying on that particular part of the examiner's handbook in arriving at your opinion?

A. Yes sir, I am.

Q. All right. What part of the handbook is that?

A. I have it marked in my handbook. I don't know where it may be here. It in effect states that no credit for unearned premium reserve may be taken.

THE COURT: Well, show me where that is. I read it and I don't remember it. That's why I am asking the question.

A. Yes, sir.

Q. Would it be easier for you to refer to your copy?

A. Yes, sir. It would.

[111] Q. Where is it?

A. It's in my briefbag. It's in a black hardbound cover.

Q. Is this it?

MR. HARPER: May I see his copy before it goes up?

Q. To restate the question, Mr. Clark, what portion of the handbook did you rely on in reaching your opinion?

A. There may be two sections, one of which is listed on page B-6, subparagraph one.

Q. Would you read that for us, if it is not too long, please.

A. May I pick up in the middle of the paragraph?

Q. Yes, sir.

A. "Unless a so-called reinsurance contract contains this essential element"...

THE COURT: Where is that?

A. Subparagraph one on page B-6, in the middle of the paragraph.

THE COURT: Okay. Yes, I see it. All right.

A. "Unless the so-called reinsurance contract contains this essential element no credit whatsoever shall be allowed on account thereof, in any accounting or financial statements of the ceding insurer, which would include all accounts involved in the contract." And there is another section somewhere. . .

MR. HARPER: This is not, may it please the Court, from the handbook but from the excerpts of [112] committee reports. Are you saying that the committee reports are. . .

A. This is in my handbook, and it's in this handbook, and if it is not from the handbook, where is it from?

MR. HARPER: It is part of the subcommittee reports. It is not a part of the recommended procedure.

A. It certainly is.

THE COURT: All right.

Q. Okay, Mr. Clark. What is the other portion to which you are referring?

A. I can't find it.

Q. Would you refer to pages B-14 through 16?

THE COURT: Well, I will help him. B-14, if you will look at the second paragraph under the Section or Portion that says "Surplus Aid Contracts", I suppose that is what you are referring to.

Q. Was this a surplus aid contract in your opinion, Mr. Clark?

A. A guaranteed profit contract is a form of surplus aid contract, yes sir.

Q. And what is your testimony in regard to this agreement?

A. I would classify it as a guaranteed profit contract.

Q. And how did this in your opinion effect the shifting of the risk of loss?

A. This particular contract, in my judgment, does not shift [113] any risk of loss, because the assuming company is always guaranteed 4%.

Q. Even though the word "guarantee" is not used in the agreement?

A. That is correct.

Q. And so since the risk of loss was not shifted, for that reason the credit taken by Georgia Credit Life for the unearned premium reserve maintained by Georgia Insurance should not have been main—should not have been allowed, is that correct?

A. That is correct. Yes, sir.

Q. When did you first see the agreement in question, Mr. Clark? Approximately? Have you seen it before?

A. Yes, sir, I had. I had—well, I first studied it during an examination of 1969 as an Examiner.

Q. Okay. We aren't going to get into the results of that examination. However, is it your testimony that you did review the agreement at that time?

A. Yes, sir, I did.

Q. Did you become familiar with all parts of it?

A. At that time, I was familiar with all parts of it.

MR. LUYTIES: No further questions.

THE COURT: All right. You may cross examine.

CROSS EXAMINATION OF MR. CLARK

BY MR. HARPER:

[114] Q. I would like for you to refer to the examiner's handbook. . .

A. Yes, sir.

Q. B-14. . .

A. Yes, sir.

Q. If I understand your testimony, you testified that this is a guaranteed profit contract?

A. Yes, sir, I did.

Q. A guaranteed profit contract is an example of what kind of a contract in your opinion?

A. Normally, in this handbook. . .

Q. No. In this handbook. . .

A. In this handbook, a guaranteed profit contract would be a contract whereby the assuming company would always be guaranteed a commission based on a sliding scale whereby it would run from one to five percent, and the assuming company would never be on a risk. It would have a break-even point.

Q. Do you agree that the first sentence at the bottom of under "Guaranteed Profit Contract", which it says "guaranteed profit contracts results in immediate increase in ceded company surplus by the amount of the tentative commission received." Are you familiar with that?

A. It says "the principal characteristic is"—yes, I am familiar with it.

Q. Was there a temporary increase or immediate increase in the surplus of Georgia Life as a result of this contract?

[115] A. No, there was not. Because there was no tentative commissions paid.

Q. Now, I ask you to refer to your examination for the period ended December 31, 1969. Do you have it present?

A. I have a copy.

Q. I ask you to look at page 26.

A. All right.

Q. On page 26. . .

MR. LUYTIES: Just a moment.

MR. HARPER: I think he is familiar with this.

A. Do you have the Life Company contract, sir? Do you have the Life Company examination report?

Q. Yes. And I find here the aggregate reserve for accident and health policies on page 26?

A. Yes, sir.

Q. The amount of \$70,385.44 is after the unearned premiums on ceded insurance have gone to Georgia Insurance.

A. Yes, that is.

Q. Is that correct?

A. Yes, sir. It is.

Q. I ask you then to refer to page 51 where you have made the adjustments, change in surplus, you have shown here, have you made an adjustment in that figure in aggregate reserve for accident and health policies?

A. No sir, I did not.

[116] Q. Why not? You said that if you found a guaranteed profit contract, that the unearned premium reserve should remain upon the books of the primary insurer.

A. The contract—the examination was recessed in order that certain matters could be handled and that I could come back and verify these matters, or certain exceptions, and during the interim, the company cancelled the contract that was in effect, meaning this contract, along with several other contracts.

Q. Was it owned by someone else at that time?

A. I beg your pardon. . .

Q. Wasn't. . .

A. Yes, sir, it was.

Q. Wasn't Georgia Insurance actually sold effective September 20, 1958—1968?

A. It was sold sometimes during '68.

Q. There were new owners?

A. Yes, sir.

Q. Were there any new reinsurance agreements in effect?

A. There may have been some new reinsurance agreements in effect, but this one was in effect as well.

Q. Does your report reflect the incidence of any other reinsurance agreements in effect for that period?

A. I will have to refer to the report. Well, I simply stated that as of December 31, '69, the company had in effect two [117] reinsurance contracts which contained provisions as outlined below. This would be on life insurance.

Q. It is clear that the \$70,385.44 is an amount after the cession of insurance with regard to the agreement between Georgia Insurance and Georgia Life?

A. Yes, sir, it is.

MR. LUYTIES: What figure are you referring to?

MR. HARPER: Figure No. 2.

MR. LUYTIES: What page are we on?

A. 26.

Q. Now, is it true that for the second insurance treaty, one with Credit Life of Ohio, is it true that you made an adjustment to the surplus. . .

A. I did.

Q. For that contract?

A. Yes, sir. Yes, sir. I did, because there was a ceding. . .

Q. What was that adjustment for?

A. The adjustment was for the unearned portion of a ceding provisional commission.

Q. And you put it back on the books of Georgia Life Company?

A. I did, yes, sir.

Q. You made no comparable adjustment in the case of the reinsurance treaty between Georgia Insurance and Georgia Life?

A. I did not.

Q. Why not?

A. Because there was no provisional ceding commission allowed [118] at inception date.

THE COURT: What was the difference between the two reinsurance contracts?

A. The difference between the two contracts, sir, was the fact that between the Life Company and its parent,

there was no tentative ceding provisional commissions paid.

THE COURT: Well, under this handbook, that's the thing that made it—one of the things that made it a guaranteed profit. . .

A. One of the characteristics, yes, sir.

THE COURT: Well, go on and tell me what other differences there was between that and the Credit Life of Ohio.

A. Well, the Credit Life of Ohio, I believe, if that is the correct name, did in fact pay the First Georgia Life Insurance Company a ceding provisional commission, thereby allowing them to initially cover acquisition costs, and. . .

THE COURT: Well, as I understand in that instance you permitted what you said shouldn't have been permitted here.

A. I may—I didn't go through the ramifications of backing all the entries out between the parent and its subsidiary. One reason being, and this was discussed fully with my department because on anything controversial like this I always contact them, it was decided that it would, you know, really a waste of time in one regard, since the contract had been cancelled [119] and there was no ceding provisional commission involved in the contract between the Life Company and its parent. The reason I disallowed the contract or commented upon it as being a guaranteed profit contract is that under the terms of this contract, in my judgment, the assuming company can never be on a risk, and if no risk is transferred, then its not pure reinsurance, and the assuming company is in effect on all risks throughout the terms of this contract.

THE COURT: Well, the question I really wanted you to answer was this, I understood you to say that the only difference between this contract, that is Plaintiff's 12, and the reinsurance agreement with the Credit Life of Ohio, if that's the proper name. . .

A. Yes, sir. Yes, sir.

THE COURT: . . . was the fact that in Plaintiff's 12 they did not provide for tentative commissions?

A. That's correct. Yes, sir.

THE COURT: All right. Then did I understand you to say that you felt the Credit Life reinsurance contract was a proper reinsurance contract?

A. No, sir. It was not a proper reinsurance contract.

THE COURT: Okay. All right.

A. I adjusted for the unearned portion of the ceding provisional commission, which I guess theoretically had the same effect of backing all the entries back in, with the exception [120] of actually doing it, because part of the commissions that they initially received are not fully earned until such time—they are paid on a written basis, and whatever the term of contract states, it is adjusted to a losses incurred to premiums earned basis, which is a written basis, and generally, almost without exception, the ceding company must return part of these ceding commissions originally received, which allows them to immediately recover acquisition costs to the assuming company, so it is really a loan, or be what is considered. . .

THE COURT: But that wasn't true here, was it? Didn't they immediately transfer the premiums to Georgia Life—I mean Georgia Insurance Company?

A. Yes, sir. They did.

THE COURT: They didn't retain any—it wasn't a tentative sort of thing at all.

A. No, sir. It wasn't. No, sir. It's just the fact that the parent company was guaranteed 4%.

THE COURT: In practice is what you are saying?

A. Yes.

THE COURT: It certainly wasn't so stated in the agreement, but you say the practical effect of the contract was to guarantee them the 4%.

A. To guarantee the parent company or assuming company 4%.

THE COURT: Yes, sir.

[121] Q. Are you familiar with the fact that losses could have been above 96%?

A. I would say. . .

Q. Are you testifying that they could never be above 96%?

A. No, sir. I am not.

Q. You are not?

A. I would say it would be highly unusual.

Q. Would you doubt that in case of—experience of individual agents there were losses in excess of 96%?

A. I should think there would be agents from time to time who would have loss ratios in excess of 96%, and I should also say that their contract would be immediately cancelled. When we are speaking of losses, we are speaking of pure losses and not commissions and losses. The 96% is a pure benefit paid to a policyholder for a loss, and the net of any commission. . .

Q. Why do you think they would pay such a benefit as that?

A. I beg your pardon?

Q. Why is such a benefit paid as that? We have had testimony from a number of individuals that it is usual in the industry to pass over reinsurance in various forms and various kinds, and it is the top risk which is reinsured. It is not the anticipated risk; it is the unanticipated risk which really is reinsured, isn't it?

A. Well, then you would have a first or second or third surplus [122] contract or something of that nature, not a contract of this nature.

Q. I would like to refer back to your examination in 1969. . .

A. Yes, sir.

Q. . . . which you have made, and I would like to ask you whether you made an adjustment in the reserve of either the reinsurance or the reinsured portion that Ohio—Credit Life of Ohio or with the reinsurance of Georgia Insurance?

A. I made no adjustment in the unearned premium reserve as such. I simply provided a liability which would cover the unearned portion of the ceding provisional commission.

Q. You made an adjustment of \$7,190.00. That was the provisional commission. . .

A. Right.

Q. . . . which you thought was wrong. Now, why. . .

A. It had not been earned at that time.

Q. But no such adjustment was necessary in the reserve as far as the business reinsured with Georgia Insurance?

A. Well, if you back out all of the entries related to transferring these reserves and the ceded reinsurance balances payable and all other related accounts without getting too involved, then the net effect on surplus should be the seven thousand one hundred and some-odd dollars.

Q. That would really be an increase in surplus. That's—if you take commissions in the income before they are earned, [123] and that's what was done by a provisional commission. . .

A. Right.

Q. . . . you have really anticipated income, and so as a result you have increased surplus?

A. I have decreased surplus, but what you are saying is you would increase surplus.

Q. Well, the contract is increased surplus in kind of a gimmick type. . .

A. Yes, sir. That's true.

Q. It converts what I would call deferred income into current income.

A. Which is—it allows the ceding company to recover their acquisition costs immediately. They are required—if a company writes \$100 in premiums and assuming a 25% commission base—which would be low on this kind, but 25% commission base—then the direct writing company would only be allowed to pick up \$75.00 in assets, whereby they must pick up \$100 in liability, so for every \$100 in premium they write, assuming a 25% commission base to the agent, they are depleting surplus by \$125 or a net \$25.

Q. But not increasing surplus?

A. Depleting surplus.

Q. This contract is really a surplus burden. If anything, it's not a—to the extent of the 4% commission, it certainly would [124] not be surplus relief.

A. It is a guaranteed profit contract to the First of Georgia Insurance Company, sir.

Q. It is guaranteed, why? You don't think there is any possibility of losing it under here? And you think there is no possibility of insolvency of the primary company, is that. . .

A. The guaranteed profit concept basis, in my judgment, is based on contracts between two going concerns. Every contract must have an insolvency clause in order for it to be eligible to be treated as a legitimate contract.

Q. Isn't the guaranteed profit contract really one which results in an immediate increase to the ceding company?

A. That is one of the aspects of the contract, not the basis of the contract itself.

Q. You have made no adjustments in the insurance reserves on the case of either of these?

A. I have made no adjustment in the reserves.

Q. It follows that they must have been correct then?

A. No, it doesn't.

Q. Why didn't you adjust it?

A. I just got through telling Your Honor why I didn't adjust it. I discussed the matter with my Department. The contract had been cancelled. I went in there a month later, and it was decided it would be an exercise in futility. It's discretionary.

Q. Are you familiar with the Revenue Agent Howard Flasher?

[125] A. Yes, I am.

Q. Did you discuss this examination with him during the course of your examination?


A. During the course of my examination, no sir, I did not.

Q. Oh, you did not. . .

A. Not during my examination, no sir. The first recollection that I can recall as having talked with Revenue Agent Flasher about this examination is last summer.

Q. Well, then. . .

A. As I recall it, I don't ever recall having discussed. . .



Q. Well, Mr. Sturtevant testified that he had discussed it with him.

A. Well, Mr. Sturtevant may have discussed it with him. I didn't.

Q. Now, I also asked you had you made an adjustment in the earned surplus as a result of this tax.

A. I beg your pardon.

Q. I refer to. . .

A. From the records available, and if you noticed, I put that in the net worth section which is a contingent liability as opposed to a pure liability. The National Association of Insurance Commissioners recommends that when it is not crystal clear that a liability is pure, then the best or the acceptable route is to earmark a part of the net worth surplus, and it depleted the surplus or the net worth section of this company by zero. Now, this is done just [126] to make it a matter of record. From the records available in the company at that time, the figures I used were the only ones I had, and I think the comments were quite clear and adequate to cover it at that time.

Q. What is your understanding of a surplus aid contract?

A. A surplus aid contract would be one that would beef up the surplus in a manner that would not be acceptable, or a fictitious manner.

Q. The surplus wasn't beefed up here, was it, as a result of the agreement between Georgia Life and Georgia Insurance?

A. No, it was not, and I classify this as a guaranteed profit contract.

Q. Well isn't a guaranteed profit contract one of the examples?

A. It is a form, yes sir.

Q. You say it is not surplus aid, but it is a guaranteed contract?

A. I didn't say it wasn't, because all guaranteed profit contracts are surplus aid contracts. The fact that this. . .

Q. Will you read the paragraph at the bottom of page B-14, and explain what your. . .

MR. LUYTIES: Your Honor, this is the second or third time we have gone over that. The same questions are being asked. He is giving the same answers. He has been asked to read that particular paragraph once before. The identical paragraph.

THE COURT: Yes, but as I understood him, he conceded that [127] Plaintiff's 12 is not an illustration of guaranteed profit contracts, because one of the characteristics of it does not appear.

MR. LUYTIES: No, he is saying it is a guaranteed profit contract, but not as described in the Examiner's Handbook.

THE COURT: All right.

Q. Are you testifying that it is a guaranteed profit contract, but not a surplus aid contract?

A. No, I am not. I am testifying that it is a guaranteed profit contract without a tentative provisional ceding commission present.

Q. You testified earlier that it was surplus aid.

THE COURT: What he did though, he said the practical effect of this contract was to guarantee the parent company 4%.

Q. Though it did not technically meet the requirements?

THE COURT: That's right. This has been his testimony. But it doesn't meet what's been described here.

Q. No further questions. Oh, I do have one further question. Are you familiar with the fact that this reinsurance treaty had been fully approved, no adjustment in surplus made or suggested in examinations for the three years ending December 31, 1964, and for the three years ending December 31, 1967?

[128] A. Of course, the contract being dated in 1961 would have been covered in both of those examinations. The contract dated 1964, was it?

Q. Yes.

A. While I have not read it myself, the statement of the Examiner was read to me over the phone and I am not in agreement with his statement. The examination report dated December 31, 1967, was never accepted by the Georgia Department of Insurance, nor was it dis-

tributed to other States. That's why these examination reports right here were made.

Q. Well, these examination reports are tri-annual reports required by the Georgia Law, are they not?

A. No, I believe you will find at least once in every five years, as opposed to a tri-annual. Quin-annual, is it, or whatever it is called.

Q. Are you familiar with. . .

A. I. . .

Q. Do you know a Mr. Lawrence Earl?

A. Yes, I do.

Q. Do you think that he is—were you familiar with his report?

A. Do I think Mr. Earl is familiar with his report?

Q. Are you familiar with Mr. Earl's report?

A. I am not familiar with it in contents or form other than I [129] know he did make that examination.

Q. You knew that this contract had been previously approved?

A. No, sir. I can't say that I knew it had been previously approved. All I can say is the examiner submitted his statement on it, and nothing was done about it. Silence is not consent, as far as I am concerned, and each examination stands on its own.

Q. When you start an examination do you ignore examinations that preceded by the same department?

A. When I conduct an examination and go over the corporate history insofar as the charter amendments, by-laws, conflict of interests statements and so forth, I personally look at each and every one of those things myself and put my mark on it. I look at the last examination report for the sole purpose of seeing what exceptions the preceding examiner took, so that I can ascertain that they were correct—corrected between the time.

Q. I have here the recorded examination by representatives of the State Insurance Department of Georgia as of December 31, 1967, and I find under conclusion, it is signed by Thomas Clifton.

A. That's correct.

Q. In addition to the undersigned, B. C. Clark. That's you, isn't that correct?

A. That's right. Do you see my signature in there? Do you [130] see my signature in that? You don't, because I wouldn't sign it. It's contrary to all reporting standards and practices. I challenged it, and the report was never accepted.

MR. LUYTIES: May I see that?

Q. There is no provisions for your signature, is that?

A. There isn't because I wouldn't allow it.

Q. When did you become Senior Examiner? Did you. . .

A. I have been a Senior Examiner since five—let's see—well, I qualified as a Senior Examiner when I came to Georgia; however, in order that they may see what my abilities were, I consented to come on as an Examiner, and at such time as they were satisfied with my work, then I automatically became Senior Examiner, but I had the qualifications when I came. . .

Q. But you were not Senior Examiner in 1966?

A. I certainly was.

Q. Well, why did they have two Senior Examiners on the audit?

A. I went down to do that examination by myself, and a week later appears Mr. Clifton, and Mr. Clifton being a Senior man by longevity and older than I am, and inasmuch as we never agreed on examination theory and practice, then I just automatically let him go ahead and do it, and I just told him I was going to refuse to sign it. I challenged the report, and the Chief Deputy at the time was named Jack Purdue, and the Chief Examiner should verify this, as well [131] as to Mr. Herb Parks, who testified this morning, because I told him before the examination was over I was going to challenge the report—if you want to call it a report.

Q. A man by the name of Fuller participated too.

A. A man by the name of who?

Q. A man by the name of Fuller.

A. No, sir, not in that one, he didn't. Not in '67.

MR. HARPER: No further questions.

MR. LUYTIES: No further questions, Your Honor.

THE COURT: Well, do you have any knowledge as to whether or not this particular reinsurance contract had

been disapproved by the Insurance Department of the State of Georgia?

A. No, sir, I haven't. I would say it probably had not been disapproved inasmuch as it had never been brought to their attention. The Examiner, as I recall—I am recalling from memory—in 1964, simply stated that he had reviewed the contract and the contract appeared to be in good order, which was his opinion, and based on that statement, the Department would have no cause to challenge it.

THE COURT: Well wasn't he working for the Department?

A. Yes, sir, he was.

THE COURT: Well, insofar as the Department was concerned, then for better or for worse, it took the position the he did, would it not?

A. Well, he didn't—he didn't elaborate on the contract.

[132] THE COURT: I understand that. But for better or for worse—in other words, they had to take the position that their man did, just like they would take yours if they sent you out and you came back and disapproved it.

A. If I had made a report like that, sir, I would be dismissed.

THE COURT: The fact of the matter is that the man wasn't dismissed?

A. No, sir, he wasn't.

THE COURT: So that perhaps somebody approved it?

A. Yes, sir.

THE COURT: But so far as you know, it wasn't disapproved?

A. No, sir.

THE COURT: Would you know if it had been disapproved?

A. Yes, sir, I would.

MR. HARPER: I hand you here a published report as of December 31, 1964, and you say it hadn't been considered before. How did they write it up here? It states in here this company has in effect a quota share

treaty by ceding accident and health insurance dated so and so.

A. I said that I had never read the report.

MR. HARPER: The company cedes.

A. I think you will recall I testified I had not read the report, that I had related to me that it said that the contracts were reviewed and were in good order.

[133] THE COURT: What is your question now, Mr. Harper?

MR. HARPER: Well, as I understand it, he testified that the company had not considered the contract that is specifically covered in the years before the—written up in the published report.

A. But you—it did not state—did it state the parent company was guaranteed 4%?

MR. HARPER: It's the same contract. They wrote it up?

A. But did it state that the parent company was guaranteed 4% in that write up?

THE COURT: All right. Anything further of this witness?

MR. HARPER: I would like to read to him from the deposition of Lawrence Earls who signed this report as Senior Examiner from 1961 to 1964.

MR. LUYTIES: Your Honor, that deposition has not been introduced into evidence at this time.

THE COURT: I haven't heard the question. You know this isn't a jury, let me hear the question.

MR. LUYTIES: He is going to read the statement from a deposition.

THE COURT: Maybe so, he may be using that as a preface to a question.

MR. LUYTIES: Well, it would have to be entered in evidence before it is used.

THE COURT: How could I pass on it before I hear it? Do you think I could be prejudiced?

[134] MR. LUYTIES: I hope not.

THE COURT: Well, my suggestion to you is to wait until the question is completed, and then I will rule on it.

MR. HARPER: On page 16 of the deposition, Mr. Earls' answer to the question, "In the course of your examination of the financial affairs of Georgia Life, did

you specifically consider any reinsurance in effect during the period of your audit"? Answer "Yes". Question "Did you receive and examine in the course of your audit reinsurance treaties by which Georgia Life reinsured accident and health insurance?" Answer "Yes". "I hand you here a copy of the treaty. I ask you to look at it and see whether that is a copy, that is a copy like you examined at the time. I don't have a bound copy of the thing." Answer "To give you a direct affirmative answer, I would have to go back and refer to the working papers, but from what I see here and from my memory of the items that involved in that contract, I would have to say that this is a copy of that contract. And did you study the reinsurance contract in effect at that time? Answer "Yes, Yes". Question "Could you define the term economic reality of reinsurance". Answer "I would have to start off by looking at the word risk. Risk is the whole purpose of insurance, be it life or otherwise, and an insurance company undertakes to cover, protect losses of various policy holders. Insurance companies, when they receive, of course, [135] Insurance companies, when they receive, of course, their risk and related premiums and what you have, they have limitations as to the amount of risks you can cover and want to cover because of this limitation. They work out mutually agreeable transactions with other insurance companies so that the risk is spread between more than one company, and I would say that any insurance company who enters into a reinsurance transaction looks at it from the standpoint economically, it is beneficial to me; and to that standpoint, I would say that each reinsurance transaction does have economic reality. At the time the company enters into it, it does make a good judgment as to the dollars and cents involved." Question "Did the reinsurance treaty in effect between Georgia Life and Georgia Insurance Company, the casualty company, did it have economic reality in your judgment and on the basis of your experience?" Answer "Economic reality in this case, as in all reinsurance transactions, must be measured between the amount of gain that would be generated against the loss, the amount of loss sustained. The determination I made at that time, and I think it was a correct determination, was that this

insurance treaty did have economic reality. You made a determination at that time that it did have economic reality." Answer "As of December 31, 1964, yes."

THE COURT: All right, now what is your question?
[136] Q. Do you still question that Mr. Earls went into this contract. . .

A. I never questioned that Mr. Earls went into the contract, sir.

MR. HARPER: No further questions.

THE COURT: Mr. Clark, let me ask you a question.

A. Yes, sir.

THE COURT: Did the approval or disapproval, say of this reinsurance contract, Plaintiff's 12, by the Department of Insurance of Georgia—would that have anything to do with the amount of insurance which Georgia Credit could write?

A. Yes, sir. Generally, it would. If a company writing this line of business, and being that size, would be under scrutiny from the Department, and if their writing got to the extent that it would be out of line according to the ratio set up by the Department, then the Department would probably ask them to curtail their writings.

THE COURT: All right.

NOTE: The witness withdrew from the stand.

MR. LUYTIES: The defendant calls Mr. Robert Zelten to the stand.

DR. ROBERT ZELTEN, having been duly sworn, testified as follows:

DIRECT EXAMINATION OF DR. ZELTEN

BY MR. LUYTIES:

Q. Dr. Zelten, please state your full name.

[137] A. Robert E. Zelten.

Q. Where do you live?

THE COURT: Is that Z-e-l-t-o-n?

A. E-n, sir. 340 Woodly Road, Marion, Pennsylvania.

Q. Where is that?

A. Philadelphia. Outside of Philadelphia, suburb.

Q. Where do you work?

A. University of Pennsylvania, the Wharton School. I am Assistant Professor in the Insurance Department.

THE COURT: At the Wharton School?

A. Yes, sir.

Q. What is your educational background?

A. I graduated from Creighton University in 1964 with a major in accounting. I went to the University of Pennsylvania to do my PHD and graduate work, and I received my PHD there from the University of Pennsylvania in 1967 and my major was insurance at the University of Pennsylvania.

Q. What was the subject of your PHD dissertation?

A. It was examinations of insurance companies. It looked into the question of Mr. Clark's activities, as a matter of fact.

THE COURT: What is the name of your present Insurance Commissioner?

A. In Pennsylvania, sir?

THE COURT: Yes.

A. Herbert S. Dennenberg.

[138] THE COURT: He is a rather notorious person?

A. That's right, sir. He also went to Creighton.

Q. Were you ever on any scholarships while you were obtaining your PHD?

A. Right. In fact, my entire graduate education was paid for, in addition to the tuition. There was a program I was nominated for and received a grant called the S. S. Heedner Foundation Award, which essentially finances the education of young men and women now, which are aspiring to teach insurance in colleges and universities across the country.

Q. Are you teaching insurance courses at the present time?

A. Right.

Q. What do you teach?

A. It cuts across all areas of insurance, as a matter of fact. I teach principles of insurance to undergraduates, as well as graduates. Life insurance to undergraduates and graduates and property and liability insurance prob-

lems, which has been restricted to graduate students thus far.

Q. What are you teaching right now?

A. This particular term I am teaching a life insurance course for people aspiring to be CLU's, and also two principles of insurance courses to undergraduates, and the term that just ended I taught the property and liability insurance problems course, as well as principles.

Q. Are you a Certified Public Accountant?

[139] A. Subsequent—well when I was a senior in undergraduate school I took the CPA exams, and I passed all of the parts of the CPA exam, but that doesn't qualify me as a CPA, because I haven't had the practical experience as yet, and I don't know if I will get it to tell you the truth.

Q. Why is that?

A. I am in the academic life and, of course, you have to—there is experience requirements that stipulate you have to work for two years, or some such thing as that before you are qualified.

THE COURT: They don't consider that as experience, do they?

A. Not as—no, sir, they don't.

MR. LUYTIES: Your Honor, at this time, I submit that Dr. Zelten is qualified to testify on life insurance and accepted insurance accounting principles.

THE COURT: Do you dispute that, Mr. Harper?

MR. HARPER: I don't dispute it. As a matter of fact, I got my CPA certificate and my qualifying teacher experience in come part at Northwestern, so I am sympathetic with him. I came to a better State.

Q. Mr. Zelten, have you read the stipulation of facts in this case?

A. Yes.

Q. Are you familiar with the pertinent portions of the exhibits attached to that stipulation. . .

[140] A. Yes, sir.

Q. . . . with regard particularly to the A.I.C. annual statements?

A. Yes, sir. I believe I am.

Q. And are you familiar with the provisions of the reinsurance agreement between First of Georgia Credit Life Company and First of Georgia Insurance Company?

A. Yes, sir. I am.

Q. Are you also aware of the fact that under that agreement First of Georgia Insurance Company maintained unearned premium reserves based on the insurance business reinsured by it under the terms of that agreement.

A. Yes, sir, that is my understanding.

Q. And further that Georgia Credit Life took a credit—deducted from its unearned premium reserves the reserves maintained by First of Georgia Insurance Company?

A. That's right.

MR. HARPER: On ceded insurance.

A. That's right. That's 70% of it.

Q. At this time and in view of those facts and those documents and stipulations, have you formed an opinion as to whether or not the credit claimed by Georgia Credit Life for the unearned premium reserve maintained by First of Georgia Insurance Company was correct?

A. I don't think they should have—I don't think the credit for the unearned premium on the ceded portion of the [141] reinsurance was proper.

Q. What is the basis for your opinion?

A. I don't really think that the reinsurance agreement entered into between Georgia Credit Life and Georgia Insurance Company is a bona fide reinsurance agreement. I think it is one of those sham agreements, as a matter of fact, Mr. Harper referred to in his opening statements.

Q. What is the definition of—or what is the essence of reinsurance?

A. In my mind and in most of the academic literature that I have read, it pretty cleanly delineates the definition of reinsurance as being an effective transfer of risks from a ceding company to a reinsured.

Q. And you believe there was no transfer of risk in this case?

A. No effective transfer of risk in this case.

Q. Could you get a little more specific on what you base that opinion?

A. The opinion is based on the fact that the ceding commission, or the commission paid to Georgia Credit Life, would move dollar for dollar with losses incurred on the business reinsured, or subject to the treaty, up to loss ratios of 96%, and therefore all of the loss experience directly impacted on Georgia Credit Life and not on Georgia Insurance.

Q. Dr. Zelten, what about the possibility of losses in excess of 96%? How, if at all, did that affect your opinion?

[142] A. It did not affect the opinion in this case, because in consonance with what the N.A.I.C. talks about as being an effective transfer of risks, as well as what I really believe to be the case in practice, because of the nature of credit A. & H business, the 96% potential breaking point in this case was really a remote possibility, and furthermore, even if it was reached, I think it is pretty clear that it would have been recouped in subsequent periods through the working of the recaptured provision of the reinsurance treaty.

Q. In your research, what was the average experience disclosed for percentage of loss to earned premiums for credit A & H companies during the years 1961 to '64?

A. As I can recall, I think it was in the neighborhood of 30%. Industry-wide averages were in the neighborhood of 30%, perhaps give or take a few percentages. The range may have been from 20 to 55 or something like that.

Q. Would you like to refer to the study you recently...

A. Well, there were a couple of them, Best Aggregates and Averages which have been referred to here today from time to time, compile these loss ratios, and it specifically identifies 8 or 9 or 10 companies that engage in the business, and then it has industry aver-

ages for credit A & H business, and they pretty clearly indicate that the loss ratio potential reaching 90% is quite remote; and probably even more authoritatively is the National [143] Association of Insurance Commissioners study conducted in 1970 of credit insurance, wherein they have some pretty interesting data on the loss experience in those particular lines of business.

Q. Would you like to refer to those steps?

A. Well, I can repeat it. I am referring to something called the National Association of Insurance Commissioners, the background study of the regulation of credit life and disability insurance conducted in November of 1970. This particular report was prepared because of—there were some substantial abuses occurring in the early credit insurance, not just the reinsurance, but in many aspects of it. There is a Table 7 which I refer to on page 28 which indicates that for Accident and Health, individual accident and health credit reinsurance, out of \$43,000,000 in premiums collected by 260 companies, the loss ratio was 36%. This is 1968 data. In the back of the book they have some data for 1964—similar data—which indicates the loss ratio for 14 companies, and the ratios range from a low of 10.9% to 56.4% and the average for the 14 companies was 30.5%.

THE COURT: Now, does that loss exclude the portion of the monies paid to the selling agent?

A. Yes, sir. This is the figure that is exactly comparable with the loss ratio as was described in the reinsurance treaty here in question.

[144] Q. These don't include commissions or. . .

A. No, the only thing included here is losses, the publish of loss adjustment expenses which are normally minor, but its basically the benefit payment under the contract.

THE COURT: Out of a premium dollar paid, does that mean that 36 cents of it went to losses?

A. That's right, sir.

Q. Or premium earned.

THE COURT: Or what?

A. This happened to be premium earned. There is two. . .

THE COURT: Well, there is a difference, isn't there?

A. Yes, sir.

Q. Would you explain the difference?

A. The ratios in insurance, of course, have to be comparable when you are talking about a loss ratio. It wouldn't be proper to talk about comparing losses paid to premiums earned, because then losses paid really reflect a cash transaction and actual outgo, but premiums earned is an accrual figure, and you would be comparing a cash outgo with an accrual income, so what we have to talk about in insurance, when we talk about these ratios sensibly, is losses incurred to premiums earned, or losses paid to premiums written. Either put them both on a cash basis or both on an accrual basis. This happens to be on an accrual basis, the statistics that I quoted, and the reinsurance treaty is also based on an accrual basis. [145] The reinsurance treaty in question here.

Q. So the statistics you refer to compare losses incurred to premiums earned?

A. That's right.

Q. Dr. Zelten, did you consider the insolvency clause in Article 2 of this Agreement of reinsurance?

A. Yes, I did.

Q. How, if at all, did that affect your opinion?

A. The insolvency clause didn't alter my opinion. One because the striking point, once again was—I mean the probability of insolvency was quite remote, I thought, in this case; but furthermore, I think the insolvency provision is not of the essence of the reinsurance agreement. It is in fact a condition, a necessary condition, for the ceding company to be able to take a credit for reserves, but it is not a sufficient condition to be able to take a credit for premiums that have been reinsured.

Q. Would you find insolvency clauses in both valid and invalid reinsurance agreements?

A. Yes, sir.

Q. In surplus aid agreements and guaranteed profit contracts, as well as legitimate reinsurance. . .

A. Yes, sir.

Q. Did you consider the provisions for termination of this agreement by either party in the provisions for run-off. . .

[146] A. Yes, sir.

Q. . . . under Article 9? Would you like to refer to the agreement at this time?

A. No, I think I know what it is.

Q. Okay, how, if at all, did this affect your opinion that this credit maintained by Georgia Credit Life. . .

A. About to the same extent as the insolvency clause. It is basically once again based on the remoteness of the possibility. I don't think it is a reasonable expectation. I think that it. . .

THE COURT: What does Article 9 provide?

A. That in the event that the reinsurer or the ceding company should decide to terminate the reinsurance arrangement. . .

THE COURT: Oh, termination.

A. Yes, the business would run off.

THE COURT: And in your opinion that possibility was too remote to. . .

A. Yes, sir.

THE COURT: Change your opinion in any way?

A. Yes, sir.

Q. Is this a surplus aid contract, Dr. Zelten?

A. No, it is not a surplus aid contract.

Q. Did it provide any surplus aid or surplus relief?

A. No, I don't believe it did.

Q. Have you listened to the testimony earlier presented by [147] certain witnesses for the plaintiff to the effect that there is some sort of benefit in entering into reinsurance because a ratio of premiums written to surplus is thereby reduced.

A. Yes, sir, I did.

Q. In your opinion—one, is that a reason, and secondly, is it a valid business reason for entering into such an agreement?

A. If it would allow them to expand business, it may be considered a valid reason, but in this case, it wasn't the effect of this agreement.

Q. Now, why do you say that?

A. Well, this question has come up many times, and I think I am going to have to explain it from the word go. Why we talk about this—I am sure we are referring to the 2 to 1 rule that's come up from time to time.

Q. Or 1½ to 1?

A. Yes. I think that really to put this in the proper perspective, it is going to take some explanation, and if you will bear with me, I would like to try to clarify it. The essence of the 2 to 1 rule—incidentally this was recommended by an academic guy, or a guy who wrote the trade publications many years ago.

Q. And where are you referring to the 2 to 1 rule?

A. The 2 to 1 rule is the relationship of premiums written to [148] policyholder surplus for a company, and it's a rule of thumb that is frequently used by States to gauge the solidity of the insurance organization, that is its ability to make good on its claims. This was recommended by an individual by the name of Roger Kinney, and in fact they refer to it as the Kinney Rule occasionally, and there was one time when this was actually put into a recommended revision to the New York Code, but because of the inconsistencies in applying this rule, it was obviously—it was subsequently not allowed. Now, what is the reason for the rule? I think why is 2 to 1 such an important thing, and why do companies look at it. Well, I think first of all we have to recall that it is only applicable to fire and casualty companies. No one has ever indicated that the 2 to 1 rule applies to companies writing life insurance, and I think it is quite unclear how the 2 to 1 rule has any impact in this case at all. I will not deny the fact that there are surely some limits on the amount of business a company can write, whether its life or A & H or fire and casualty. Now, as Mr. Eddy and other people have said, it's pretty clear . . .

THE COURT: Well, let me ask you right there. You say it doesn't have any relevancy to health and accident. Why doesn't it?

A. No, sir. If I said it doesn't have any—I said it doesn't have any relevance to a life insurance company.

[149] THE COURT: A life insurance company then.

A. It's a different kind of transaction. As you will notice, Mr. Eddy pointed out that a life insurance transaction, credit life policy specifically, will generate an automatic profit even in the first year it's written. He talked about the twenty-cent profit. Well, if all the business you do generates a profit, there is obviously no drain on surplus and you can write all you want, and you are better off if you keep on writing. Now, because of the peculiar accounting characteristics and the peculiar accounting rules, the fire and casualty have to follow, however—the regulators have essentially told them this; listen, when you write the policy, you are on the hook for a year, and we are going to assume that if that policyholder wants to cancel at any time, he can get back the pro-rata share of the gross premium, so we are going to require that you maintain the gross premium reserve until the policy expires. You can take it into income as the policy expires, but not ahead of time; but to make sure that you really are a solid outfit, we are going to make you charge to income immediately the entire commission you pay on the business. So as we have indicated before, if there is a 50% commission for a dollar premium, that automatically when a fire and casualty company writes a premium, surplus is going to be reduced by 50 cents, because [150] what they have done is collected a buck, but they cannot take it into income. It's a liability until they earn it; but on the other hand, the 50 cent commission that they pay to the agent is an expense immediately and is charged to the income statement. So if you look at an income statement with zero income and fifty cents in outgo, it is pretty clear that surplus is going to be reduced by fifty cents. Now . . .

THE COURT: But the company's making money?

A. It could be. It could be—the experience could be exactly in consonance with what they assumed in calculating the premium. Now the next year, of course, profits can be overstated, because they won't have that commission expense and it sprays equity in the unearned premium reserve, sometimes is used to refer to that overstatement. The unearned premium reserve is set up apart, but really you don't need it at all to pay losses and all that. Now, the 2 to 1 rule is looked at by the regulators as a symptom of a possible problem. Now, if they write—if they have a dollar's worth of surplus and they write a dollar's worth of business, what is going to be the surplus after they write the business? It's going to be fifty cents, because for every dollar they write, they cover a fifty cent commission, therefore surplus is going to go down. If they write two dollars in premiums, what is going to be their loss on [151] that transaction? It's going to be a dollar. Fifty percent of two dollars will be a dollar loss, and surplus will be depleted. You know, I started out with a dollar surplus. They write two dollars worth of business. I want to make sure that that is clear. So surplus will be exhausted. So if in fact a company paid out fifty cents in expenses immediately under its business, it's pretty clear that if they did two hundred percent of the business in their surplus, their surplus would be exhausted.

THE COURT: Well, 2 to 1 would be it, then.

A. 2 to 1 is it, yes. However, as I said, that is a symptom. It is only an indication of a possible problem. A person and a good examiner, and any one who is evaluating a company soundly is going to go beyond that. He is not going to stop at 2 to 1. The reason 2 to 1 is looked at as the rule of thumb is that it is assumed that a company that is writing 2 to 1 is depleting its surplus. Okay. Now, if a company should start to write 5 to 1 or 10 to 1, one of the things they do to make sure that surplus is not depleted is to enter into a reinsurance contract wherein they will get a front end provisional commission and boost the surplus up so that the net effect isn't too bad. It still

looks like 2 to 1. The basic reason why 2 to 1 is so important is that the expansion of business creates a drain on surplus. Now, in order for me to be convinced that a reinsurance arrangement [152] will help this situation, I am going to have to be somehow convinced that surplus is in fact helped by the reinsurance arrangement. In fact, it seems to me that surplus, even through the reinsurance agreement, was not at all helped in this situation. In fact, it has been admitted that it in fact decreased the surplus.

Q. Then you are saying that it is not a surplus aid contract?

A. This is not a surplus aid contract. There is no way in the world it will work out that way.

Q. So that after noting the 2 or 3 to 1 ratio, being alerted, the examiner would have analyzed surplus in what context?

A. I think he would have had to look at even the quality of the surplus, you know. If there was an effective transfer of the risk through the reinsurance agreement, the quality of the surplus is probably pretty good, because the reinsurer is on the hook. Right? They have taken some risks. In this particular case, the reinsurer took no risks. It was the primary company that was still on the hook. So it allowed to inflate or allowed to transfer those unearned premium reserves doesn't really—I don't think it helps the problems at all in terms of capacity.

Q. Back to the ratio, Dr. Zelten, do you observe the ratios...

A. I would like to say one thing. I am not at all convinced that the 2 to 1 ratio is very applicable in this situation. I think it is maybe in a sense, and I am only referring to [153] it because it has come up earlier today. I, as a regulator, would not place very heavy reliance on the 2 to 1 ratio in this kind of a company, this sort of a hybrid company.

Q. Would that be determinative, considered, or what would you do as a regulator?

A. If what?

Q. If you determined at the time there was say a $2\frac{1}{2}$ to 1 ratio?

A. I would go in and look at the surplus. I would look at the nature of the business to find out whether or not that surplus was adequate to meet the risk that the company actually had.

Q. And how would you determine that?

A. I would look at the policies that were issued. That's basically what they are on the hook, for, the lines of business they are in. Secondly, I would have to look at reinsurance arrangements they entered into, I suppose, to find out whether or not they effectively transferred any of that risk.

THE COURT: Now, who are you looking at it, through the eyes of the Insurance Commissioner who is looking out for the interest of the public, or accountant, or working for the Federal Government on Internal Revenue?

A. In that case, I think most of my remarks thus far have looked at it from the standpoint of the Insurance Commissioner.

[154] THE COURT: The public?

A. Right. Right.

THE COURT: Well now, why. . .

A. I would say this. I guess I would say even from a sound accounting standpoint, to recognize the true liabilities of the company, I would also not allow—I would require that the ceding company set up the unearned premiums on that business.

THE COURT: Well, insofar as the public is concerned, what difference does it make whether the money comes from Credit Life or from Georgia Insurance, as long as they are protected?

A. They don't have a contract with Georgia Insurance, though.

THE COURT: Well, you have got an Insurance Commission, though, you know, that kind of supervises this thing.

A. Well, yes, they do. I don't think there is any question but that they supervise it. The point is that the Insurance Commission. . .

THE COURT: They would not approve it if Georgia Insurance weren't going to be a solvent company. In other words, the company standing behind the policy itself.

A. I think you are right. Assuming that they examine the contract, they will not approve a contract which they feel probably doesn't meet the best interests of the policyholder.

THE COURT: I mean the mere fact you have got a contract— [155] here had a contract with Georgia Insurance, as far as the policyholder is concerned, it seems to me wouldn't make any difference except for the solvency or insolvency of the company that has to pay for that policy.

A. I am not sure I got. . .

THE COURT: Well, what I am—what you said was there was not any direct contract between the policyholder and Georgia Insurance. I say that is not too significant if you had a contract with a company that is going insolvent. What differences does it make whether you have a contract with them or not, you didn't get paid, in the event of a loss.

A. There is nothing wrong with your statement.

THE COURT: What I am saying here, as far as the Insurance Commissioner is concerned, he is thinking in terms of protection of the public. Now, whether it came from Georgia Credit or Georgia Insurance is not too significant as I understand it.

A. Right.

THE COURT: That's why I ask you through whose eyes you were looking at it.

A. Right. I was looking at it through the regulator's eyes. I mean the way they think.

THE COURT: Now, from the regulator's eyes, as far as I could tell, and apparently the way they felt here, it didn't make a lot of difference to them, [156] as long as the public was protected, and they felt they were protected.

A. That would have to be the assumption based on the examine report, I guess.

Q. My original question. . .

THE COURT: I am sorry to have digressed, but I wanted to explore this facet.

Q. Well, I would like to—my original question was, what effect would a ratio have on a credit life company considering entering into a reinsurance agreement? Now, in view of—given that question and in view of the way you look at how the regulator's would consider a ratio, what is your opinion as to any business reasons for entering into the reinsurance agreement we have in this case where no surplus relief was provided?

A. I am not sure I followed you all the way.

Q. All right. Earlier there was testimony that there was not surplus—surplus relief was not one of the purposes for entering into this agreement.

A. Right.

Q. However, there was the purpose of attempting to limit the ratio of net premiums—of premiums written to surplus.

A. Okay. That doesn't mean anything to me. I mean, you can try to limit that percentage all you want, but as far as I am concerned, it is really the essence that counts. [157] What is the result? And that is just—you know, that is the window; that is what you see when you look at the company, but it is the result that is important.

Q. And the regulators can go to the result, is that what you are saying?

A. They should go to the result. Now I—you know, this may be off the point, and maybe you'll tell me to be quiet right away, but it is common knowledge and first-hand knowledge for me, because I did my PHD dissertation in this area, that the quality of regulation is extremely unequal across the States, and the general level of it—the general level of it is not. . .

Q. Well, before you go any further, just how does this relate to the significance of lowering the ratio between premiums written and surplus in the eyes of a company like Georgia Credit Life?

A. Well, subsequent to the reinsurance agreement, if you look at the net premiums written by Georgia Life,

it is clearly going to be less than without the reinsurance arrangement on the surface.

Q. Did you observe the ratios for the four years of suit?

A. Right.

Q. And what were those ratios?

A. After the reinsurance arrangement?

Q. Yes.

A. After the reinsurance arrangement, they were on the order of—I think it varied, but it was like around one to one I think [158] in '60. I would have to refresh my memory. But then it went up to like 1½ to 1 in '64, perhaps something like that.

Q. Would you like to refer to the annual statements?

A. Right. Or there was some schedule I saw that I would much rather refer to. I thought I saw some schedule where it showed, maybe a letter or something that I had looked at. It was talked about earlier this morning, as a matter of fact.

Q. Apparently it is mixed with the exhibits in the statements. Here is a letter. Is this the letter you are referring to?

A. Yeah. Premiums written to premiums ceded. All right, this particular statement indicates premiums written in '61, there were \$260,000; in 1964, they got up to \$837. It is my recollection of the annual statements that surplus in 1961 was, I should recall—I know it was over \$200,000, which would indicate that the writings were about 1 to 1.

Q. I believe Exhibit 14 is the 1961 statement of Georgia Credit Life.

A. The surplus in fact in 1961 was 453,000 and premiums written was 260,000 but this is A & H after reinsurance, I think, so it may not be a good thing to look at; and then you go up to 1964—the surplus in 1964 was \$611,000 and the premiums written in 1964 were \$837,000.

MR. HARPER: May I interrupt a minute? You are using premiums without the life figure in order to. . .

A. I stated that, yes, sir. But as I also said, the life figure— [159] that if Mr. Eddy's testimony is true, all

the life business produced an immediate profit. It doesn't seem to me that we would have to consider the life premiums. The more life they would write the better off they would be.

MR. HARPER: It would effect the ratio, though.

A. Right.

MR. HARPER: It would actually lower the ratio.

Q. For an equal amount that the denominators increased and the numerators increased, the ratio decreases.

A. Right. If in fact you start with a ratio that is less than one.

Q. What is the effect of the reinsurance agreement, from what you can tell on your analysis, on the ratio of premiums written to surplus?

A. Well, ostensibly, on the surface, if you were just to look at the net premiums written by the company and relate that to the surplus, it would be smaller. There is no question about it, I think; but when in fact you look at the risk that the company had, the policyholders are no better off. All right? And that is really what the policyholder is concerned about. He is no better off under this kind of arrangement, because for the same amount of risk—for the same amount of risk, he has got less surplus standing behind him, and the fact that it was transferred to the—to the reinsuring company didn't really benefit him at all.

[160] Q. Dr. Zelden have you had occasion to study Plaintiff's Exhibit 22, and this refers to the letter from General Reinsurance Corporation quoting terms for a reinsurance agreement?

A. Yes, sir, I have.

Q. Would you like to have a copy of it?

A. Maybe I would.

THE COURT: Why wouldn't the assets of both companies be involved here with respect to policyholders?

A. In a final result from a policyholder's standpoint, that is probably true.

THE COURT: That's what I want to ask you. Wouldn't it be fair to state that here the assets of both companies would really be there to back up a policy.

A. That's true. I think it is, but in relation to the two to one rule, you don't look at surplus of both companies.

THE COURT: Oh, yes, well, but as you pointed out, that is a kind of nebulous kind of rule anyhow as applied to this type of business.

A. Right.

Q. What is the purpose of a reinsurance agreement, Dr. Zelten, to protect the policy owner or to protect the ceding company?

A. To protect the ceding company.

THE COURT: Well, but it is going to help the policyholder too, [161] isn't it?

A. But that's the point.

Q. What is the basic purpose of it?

A. I mean that is not the intention of the reinsurer entering into the contract, to benefit the policyholder, I don't think.

Q. Isn't this like requiring an insolvency clause in every reinsurance agreement, no matter how much surplus aid is created or not?

A. I think that is a fair comparison.

Q. The insolvency clause is for the protection of the policyholder?

A. Right.

Q. In the letter before you quoting terms from General Reinsurance Corporation, what kind of reinsurance agreement is that, in your opinion?

A. This is a surplus aid reinsurance agreement.

Q. How does it provide for surplus aid?

A. It provides a front end commission, a provisional commission of 50%, and in most other respects, with a few differences, it is similar to the agreement that we are looking at now with some important differences I feel.

Q. In your opinion, is that valid reinsurance?

A. Is this valid reinsurance?

Q. Yes, from what you can tell from that letter.

A. This is not valid reinsurance. A surplus aid contract, in my opinion, is not valid reinsurance. It may serve a valid [162] business purpose, but it is not valid reinsurance.

THE COURT: What valid business purpose would it. . .

A. The question of the surplus is actually benefited by the provisional commission under a surplus aid contract. Surplus in fact will be increased. Whether in the long run it is going to work out that way, that is the effect of it on the surplus.

Q. This is a surplus aid agreement. Now, under that agreement. . .

THE COURT: There you have tentative. . .

A. Yes, sir. There was a 50% provisional commission provided in that particular. . .

Q. What are the differences between that agreement, other than this tentative commission, the differences between the terms of that type agreement, and the terms of the agreement in dispute here?

A. Had Georgia Credit Life entered into this policy would not have been as advantageous to them as the contract they entered into with Georgia Insurance Company for a couple of reasons. First of all, the ceding commission, the way the commission arrangement worked out in this particular policy, was not a dollar-for-dollar exchange of losses between the primary company and the ceding company for loss ratios above 70% or below 20%. Am I—let me expand on that for a moment. In the contract that was in fact drawn up between Georgia Life and Georgia Insurance, the commission to be paid to Georgia Life was to be [163] determined by subtracting from 96% the loss ratio of the business reinsured. So for example, if losses paid to premiums earned were 20% during the quarter, the commission to Georgia Life would have been 96% minus 20% or 76%. Under this particular contract, that procedure would apply for loss ratios between 70% and 20%. However, this contract has a maximum commission and a minimum commission, so that for loss ratios below 20%, the reinsurer's profit under this contract would be greater than 4%, and if the loss ratio is over 70%, the reinsurer's profit would be less than 4%.

Q. In your opinion, does that type of reinsurance agreement provide for any shifting of the risk of loss?

A. It is a question of degree. I think clearly more than in the contract in question, clearly more than the Georgia Credit Life contract. Whether it is enough, whether—when you talk about 70%, now whether that's remote or not is getting pretty close. I would say that there is a possibility that the loss ratio on credit life could possibly hit 70%. It wouldn't stay there for long, but it could get there much more easily than it could get to 96%.

Q. Is that agreement, as far as you can tell, or that proposal, include adjusted carry-over provision?

A. It is not clear from this. According to this agreement, it did not.

[164] Q. And what other differences were there between that proposal and the reinsurance agreement in dispute?

A. Well, there was a provisional commission on this, of course; also the effective date. It is 12:01 A.M. rather than 11:59 P.M., which while maybe two minutes doesn't have much significance, when you are talking about 11:59 on December 31, of course, it could have significance; but for the most part, it is not normal for reinsurance. . .

MR. HARPER: May it please the Court, I am not sure what he is referring to. I mean, is that just a standard contract?

THE COURT: Well, it's. . .

A. This is the contract you received from General Reinsurance Corporation, the one you based your contract on. This was—it is more normal currently to have a 12:01 effective date. It's more common to have a 12:01 effective date in this contract.

Q. Dr. Zelten, what's a stop loss contract, stop loss reinsurance agreement?

A. Well, a stop loss reinsurance contract is one wherein a certain percentage of every risk is not transferred to the reinsuring company. The kind of question we have, the kind of contract we have in the Georgia Credit Life case is a pro-rata contract or quota share contract, as we have been referring to it, wherein 70% of every premium written has been ceded. A stop loss contract, on the other hand, [165] is a contract under

which the reinsurer only becomes responsible if in fact losses exceed a certain percentage. For example, we could have an excess of loss or a stop loss contract where the reinsurer would become liable only when the loss ratio exceeded 96% for the line of business in question.

Q. Assuming you didn't have a deficit carry-over provision in the reinsurance agreement under question, would this then resemble a stop loss agreement?

A. If the Georgia Credit Life contract did not have the deficit carry over provision, would it be a stop loss?

Q. Yes.

A. Yes, I think it could be characterized as a stop loss.

Q. Now, in that sort of case where you have a stop loss agreement, say, for losses in excess of 96% of earned premiums, what kind of reserve would be maintained by the reinsurer?

A. Well, the reinsurer would quote the ceding company a commission of "x" percent of a block of business assumed for example, maybe 2 percent of the applicable block of business. . .

Q. It wouldn't be 70% though?

A. No, no. It would be a smaller amount, because his liability is very contingent in this case, and he would have to set the premium he collected up as an unearned [166] premium reserve, related to that particular transaction, and account for it in the normal way that unearned premiums are accounted for.

Q. All right. Do I understand you correctly to say that the reinsurer would maintain some sort of unearned premium reserve of his own?

A. Right.

Q. In that event, would the primary writer be allowed to receive a credit for the unearned premium reserve maintained by the reinsurer?

A. No.

Q. Why not?

A. On the stop loss portion of the business?

Q. Yes.

A. No. It's just not particularly related to any—to those policies. It is not a pro rata portion of each of the

losses. You know, there are different contracts and the provisions of all reinsurance agreements, you know, aren't alike.

Q. Let me review. . .

A. Let me—maybe the best way to say it would be it would be possible to get that kind of protection without having to have bought a kind of contract where the premiums would have been transferred.

Q. You are saying that is not the sort of situation we had here, [167] is that correct?

A. Right.

Q. Let me read to you a portion from the deposition of Lawrence Earls, page 33, a short question and answer. "Question. And reinsurance was in fact really within the laws and regulations of the State of Georgia? Answer. Yes." This is Mr. Earls. "It appears to me that this 96% is a stop loss situation, both as to expenses and losses type situation." Now, overlooking any mistaken assumptions you may have made there as to commission, etc. that might have been covered by the reinsurance agreement, is this the type of stop loss arrangement you just described?

A. I don't really understand what he said. He said a stop loss as regards to commissions and losses. This reinsurance provision didn't provide any indemnification for expenses at all.

Q. That's right, but assuming we didn't have this part in here about expenses, is our situation a stop loss type situation?

A. I would say that would be the temporary benefit without that recapture provision.

Q. Without the deficit carry over?

A. Right. I think that is an adequate description of what the effective nature of this contract is.

Q. Thank you very much. I have no further questions.
[168] THE COURT: Any questions on cross examination, Mr. Harper?

CROSS EXAMINATION OF DR. ZELTEN

BY MR. HARPER:

Q. Mr. Zeltén, will you give us an idea approximately in accident and health insurance, how much you get for a dollar premium? How much coverage you get? \$500.00 or \$200.00?

A. I don't understand. How much accident and health . . .

Q. How much. . .

A. . . . You would never get \$500 coverage for a buck premium.

Q. Well, let's say on a one year loan, for example. The agent says, "I am going to charge you \$30.00 for the accident and health insurance."

A. Okay.

Q. Now, approximately how much coverage would you get on such a premium?

A. For a \$30.00 premium? The rate is \$2.00—\$1.80 per thousand, I think. \$1.80 per thousand.

Q. So \$30.00 would run up to quite a bit of coverage.

A. Let me think a second. I am not sure if it is \$1.80 per hundred or a \$1.80 per thousand.

THE COURT: That's a big difference.

A. Yes, it is. So I really can't say that I know what the premium would be. The number \$2.00 or \$1.80 sticks in my mind, but I can't know if it applies to a hundred or a [169] thousand.

Q. Well, without taking that into account, can you really testify whether a loss is a possibility or not, without taking the insurance coverage provided for \$1.00 of premium?

A. All I can do is look at the experience of the business, the way it was actually developed.

Q. Then your testimony here is really from hind sight, is that correct?

A. Sure it is. Sure it is.

Q. Do you believe that in 1961 that anybody would have known they might not lose any money at all on accident and health insurance?

A. I don't understand. Are you talking about do I know prospectively?

Q. Prospectively. Looking ahead. When you testified that you looked back do you think that everybody back at that time would have ever seen a reason to worry about the business?

A. Of course.

Q. So they could have adopted this with real business purpose just in order to cover the possibility?

A. Sure. Sure. I think they could have.

Q. Now we talked about a guaranteed profit contract and various kinds of contracts, and as I understand your testimony, it relates exclusively to the regulatory agency's position?

[170] A. No. Well, that's the way I answered it, but I also said that even if I was looking at a company I would think from a generally accepted accounting standpoint, if I was the auditor, this is my opinion.

Q. If you were looking at it from the generally accepted accounting principles, what differences, if any—you said there would be no differences at all?

A. I think that in this particular contract—I think from a generally accepted accounting principles point of view I might recognize something in the nature of a surplus aid contract. But in this particular contract. . .

Q. You would recognize it as possibly being good?

A. I would recognize it as possibly being a transfer or it would allow I think the increase in the surplus.

Q. It would allow it from an accounting standpoint?

A. Right.

Q. Now you testified about the 2 to 1 ratio, and I take it that you think other matters should be considered, is that the substance of your. . .

A. Right.

Q. You know for a fact though, don't you, that many commissioners, such as the State of Georgia, did impose this rule with real certainty and assurance?

A. Well it may have been a ruling, it certainly wasn't a statute. It wasn't in the law.

[171] Q. No, but none of the—none of this handbook is in the law either.

A. That's right.

Q. Now, if it enabled this company, well let me ask you this, do you think that with these restrictions on the ratio of unearned premiums to policyholder surplus, do you think that in fact they were able to write new business and build and expand?

A. I beg your pardon. You mean the way in fact they were allowed to treat this reinsurance treaty, did it allow them to expand? Yes, the way they were permitted to effect the reinsurance treaty did allow them to expand. My testimony was that it shouldn't have been allowed.

Q. From a regulatory point of view?

A. From any point of view. It wasn't an effective transfer of the risk in my opinion.

Q. Well, if it results in profit, I am sure the Internal Revenue Service doesn't object to expanding business, does it, and rising to even higher brackets of income and...

A. I can't speak for the I.R.S.

Q. You have no opinion on whether the testimony and the principles we have testified from should be applicable for federal taxes?

A. Well I know that regulatory accounting does not govern the I.R.S. taxing procedure in insurance company cases.

[172] Q. Well, in your opinion as a student of insurance, do you see any reason why it should effect insurance computations...

A. That question didn't...

Q. . . . of income. You really have testified then from a regulatory point of view?

A. I think I said before that what my opinion would be also from a general accepted accounting point of view too.

Q. As I understand it, you said that the policyholder really got no additional benefits as a result of this?

A. Yes, I would say that is true. When you follow the transaction through he was still looking to Georgia

Life for his benefit payment, and even though Georgia Life had transferred it to Georgia Insurance, the ultimate disposition of the payment would have been out of the coffers of Georgia Life Insurance Company.

Q. Do you think that the added surplus, the unappropriated surplus of the parent company, was not an added safety factor?

A. The surplus of the. . .

Q. Georgia Insurance, the parent. It was testified they had substantial surplus.

A. But if they took the reinsurance business, surplus would have been depleted to the extent of the unearned premium reserve that they took credit for.

[173] Q. Are you speaking now from Georgia Insurance point of view?

A. Georgia Insurance.

Q. Well. . .

A. They would have assumed. . .

Q. Of course it would be depleted, but that's—there is an advantage, a corresponding advantage, that follows through to Georgia Credit Life, doesn't it, and to the policyholder?

A. Right. Right. Yes, sir.

MR. HARPER: I have no further questions. If this is a stop loss treaty, would the result of that be to pass the risk on to the reinsurer?

A. Which risk?

Q. The risk of loss on the policy?

A. No, sir.

Q. What—would it pass any risk on?

THE COURT: Well, he said up above—he has testified that it did. . .

A. About 96%. There was some temporary protection, yes, sir.

MR. HARPER: I have no further questions.

THE COURT: Anything further?

MR. LUYTIES: Yes, one more question, Your Honor.

REDIRECT EXAMINATION OF DR. ZELTEN

BY MR. LUYTIES:

Q. Dr. Zelten, did the ceding company in this instance, did [174] Georgia Credit Life attain any benefit other than the tax benefit through entering into this reinsurance agreement in your opinion?

A. In my opinion, they did not.

THE COURT: All right. Anything further?

RECROSS EXAMINATION OF DR. ZELTEN

BY MR. HARPER:

Q. Are you questioning that this may have made it possible for them to expand their business?

A. I said ostensibly it may have looked that way to someone who didn't know what the nature of the business really is, but in true effect, when you look at the result of this transaction this did not enable them to expand business.

Q. That's unless the 2 to 1 rule is really applied and believed in.

A. Oh. Okay, if it applied to this company, yes.

Q. Were there any advantages in this contract as to Georgia Insurance's parent, the reinsurance company?

A. Well to the extent they could administer that block of business for 4%, they made some money.

THE COURT: Anything else?

MR. LUYTIES: No further questions.

THE COURT: Let me ask you, Doctor. What other legitimate purpose could this reinsuring agreement that they had [175] have other than the tax consequences?

A. That's the question I thought I just answered from Mr. Luyties. It's my opinion that this particular contract did not benefit Georgia Credit Life in any way from a business standpoint. Unless and notwithstanding the point that if the 2 to 1 rule had been invoked and vehemently enforced on this company that particular transaction, the reinsurance transaction may have allowed them to expand business, but it is also my opinion

that a good insurance commissioner and a good regulator would have seen the contract for what it was.

THE COURT: Well I understand that, but that is from the standpoint of the insurance commission, but from the standpoint of the ability of this company to expand its business more quickly, I believe you testified that you thought it did have that result. Did I understand you to say that?

A. No, I don't think so. The way I considered the reinsurance transaction it didn't give them that.

THE COURT: Just a moment ago you changed it. But initially you said that yes that was what—but you would disapprove it, but you did feel that it would permit it to expand more rapidly. Did you change your opinion on that?

A. It's almost a semantical thing, and I have to make sure we are talking about the same thing. Did the effect of the [176] reinsurance agreement allow them to write more business than if they did not have the reinsurance agreement?

THE COURT: Yes. Your testimony was that the way this reinsurance agreement was treated by these two companies would have permitted Georgia Credit to expand more rapidly. This is what you said. Now, have you changed your mind about this?

A. I said the way the transactions actually went about, and the way they were approved up to this point, it did in fact give them that.

THE COURT: All right, then I have it correct. But you said you would not have approved it.

A. No, sir.

THE COURT: Yes, all right.

MR. HARPER: I am going to ask one more question, and that is why are to many of these treaties entered into, and I guess we agree that they are, at arms length, by people who have never known each other before? The reinsurance business and the accident and health insurance is big business. Why. . .

A. That—it is my opinion that there are treaties like this, but if you say this is the General Reinsurance letter which you referred to previously in some other

discussions, it is my opinion that the contract that Georgia Credit Life has is not comparable to the type of contract that is [177] engaged in in an arm's length transaction.

Q. Why do you say that?

A. First of all because there is a dollar for sharing, all the way to 96%.

Q. But there is no provisional ceding?

A. Well it is just a question of timing. It doesn't have any effect on the ultimate profit.

Q. Isn't the timing important if you are converting deferred income into current income?

A. Yes, sure it is. And furthermore, the thing I didn't point before was that this particular contract from General Reinsurance didn't give the Georgia Credit Life the option of increasing the quota share. . .

Q. Well that is General Reinsurance. I am certain that that will not reflect all the—you are not testifying that is an agreement, are you.

A. No, no.

Q. That is just a quotation of prices for quota share reinsurance between certain. . .

A. Right. Right.

Q. It is really not the contract.

A. Right.

Q. And under that the maximum commission could have gone to 70%.

A. The commission, but not the amount of business ceded. The [178] amount of business ceded could have never gone above 60%.

THE COURT: Under your arrangement here it could have gone to 87%, couldn't it?

MR. HARPER: Yes sir. That is for the other commission. That is for the expense commission and not income commission.

MR. LUYTIES: To get this in proper context again, I believe, one question is necessary. In your opinion, what is the basic purpose of reinsurance? Is it to possibly look better in the eyes of the State Insurance Commission on an examination or what?

A. Well, you know, there can be many incidental reasons. The primary ingredient of reinsurance are the desire—or the motivating fact of entering into a reinsurance agreement. The essence of it is, it's an attempt by the ceding company to effectively transfer some risk it is exposed to that it really doesn't want to incur.

Q. Can you have a legitimate reinsurance agreement under accepted insurance accounting principles without a transfer of risk?

A. I don't believe it is possible.

THE COURT: I thought I heard some allusion to the contract entered into following the elimination of this one with some Ohio Company, am I correct?

MR. LUYTIES: I think that would be simultaneously with...

MR. HARPER: That was a new company, Your Honor.

[179] THE COURT: And there was no difference between that one and P-12?

MR. LUYTIES: Well, there was.

THE COURT: Well not much. What was it?

MR. LUYTIES: That fell under provisional ceding commission, I believe.

THE COURT: All right in fact it was worse. Well, why would the company enter into such a contract?

A. Who?

THE COURT: Any company. I mean any of these insurance companies. I mean why would they, if they weren't in some fashion being aided either in expansion of business or by the transfer of some risk.

A. Or taxes. It is just my opinion of these treaties that for the most part they are for tax reasons.

MR. LUYTIES: Well, the question is what about the provisional coverage initially, what benefits are involved when you have that sort of agreement. A regular surplus aid agreement.

A. Well, the way the N.A.I.C. is enforcing it now, none whatsoever, because they won't allow the credit for the front end commission.

THE COURT: Yes, for the commission.

MR. LUYTIES: But before that.

A. Well before that it was different.

THE COURT: Well, here it wouldn't have made any difference [180] between these two companies; not really.

A. You mean whether there was a front end commission or not?

THE COURT: Yes.

A. Except that I guess that would have clearly thrown it into the N.A.I.C. Handbook as a surplus aid contract, and maybe that, you know, is not a necessary way.

THE COURT: Yes. I have no further questions.

END OF PROCEEDINGS.

[PLAINTIFF'S EXHIBIT 10]

FIRST OF GEORGIA LIFE INSURANCE COMPANY

Computation of the Ratio of Life Insurance Reserves to Total Reserves of First of Georgia Life Insurance Company for Each of the Years 1961 thru 1964, Inclusive.

	1960	1961	1962	1963	1964
Life Reserve	\$ 70,051	\$ 80,718	\$ 92,823	\$137,325	\$166,471
Other Reserves	77,528	151,177	240,306	373,272	408,581
Less Reinsurance					
Other Reserves	—	(80,272)	(148,659)	(237,726)	(260,251)
Net Other Reserves	77,528	70,905	91,647	135,546	148,330
Total Reserves	\$147,579	\$151,623	\$184,470	\$272,871	\$314,801
Qualifying Computation					
Life Reserves					
Beginning Life Reserves	\$ 70,051	\$ 80,718	\$ 92,823	\$ 92,823	\$137,325
Ending Life Reserves	80,718	92,823	137,325	137,325	166,471
	150,769	173,541	230,148	230,148	303,796
Mean	75,384	86,770	115,044	115,044	151,898
Non-Life Reserves					
Beginning	77,528	70,905	91,647	91,647	135,546
Ending	70,905	91,647	135,546	135,546	148,330
	148,433	162,552	227,193	227,193	283,876
Mean	74,216	81,276	113,597	113,597	141,938
Mean Reserves					
Life	75,384	86,770	115,044	115,044	151,898
Non-Life	74,216	81,276	113,597	113,597	141,938
Total	\$149,600	\$168,046	\$228,641	\$228,641	\$293,836
Ratio of Life Insurance Reserves to					
Total Reserves	50.39%	51.63%	50.32%	50.32%	51.71%

[PLAINTIFF'S EXHIBIT 11]

Defendant's Computation of Reserves

	12/31/60	12/31/61	12/31/62	12/31/63	12/31/64
Life Reserves*	\$ 70,051.00	\$ 80,718.00	\$ 92,823.00	\$ 137,325.00	\$ 166,471.00
Unearned premiums and unpaid losses (A&H) reserves					
Per taxpayer*	\$71,026.00	\$62,250.00	\$ 74,824.00	\$116,671.00	\$123,580.00
Plus reinsurance	—	\$80,272.00	148,659.00	237,726.00	260,251.00
	<u>71,026.00</u>	<u>142,522.00</u>	<u>223,483.00</u>	<u>354,397.00</u>	<u>383,831.00</u>
Other reserves*	6,502.60	8,655.05	16,823.23	18,875.56	24,750.40
Total reserves	<u>\$147,579.60</u>	<u>\$231,895.05</u>	<u>\$333,129.23</u>	<u>\$510,597.56</u>	<u>\$575,052.40</u>
	Mean of Reserves				
	1961	1962	1963	1964	
Life reserves*	\$ 75,384.50	\$ 86,770.50	\$115,074.00	\$151,898.00	
Unearned premiums and unpaid losses (A&H) reserves	106,774.00	183,002.50	288,940.00	369,114.00	
Other reserves*	7,578.83	12,739.14	17,849.40	21,812.98	
Total reserves	<u>\$189,737.33</u>	<u>\$282,512.14</u>	<u>\$421,863.40</u>	<u>\$542,824.98</u>	

Percentage of life reserves to total reserves

39.731%	30.7139%	27.278%	27.983%
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* Amounts are not in dispute. Plaintiff disputes the amount of unearned premiums and unpaid losses (A&H) reserves attributable to reinsurance and the amount of total reserves to the extent they include such amounts.

[PLAINTIFF'S EXHIBIT 12]

AGREEMENT OF REINSURANCE

No. 1

between

FIRST OF GEORGIA INSURANCE COMPANY
Augusta, Georgia

and

FIRST OF GEORGIA CREDIT LIFE COMPANY
Augusta, Georgia

Effective: December 31, 1961

No. 1

THIS AGREEMENT, made and entered into as of December 31, 1961 by and between the FIRST OF GEORGIA INSURANCE COMPANY, Augusta, Georgia (hereinafter called the "Reinsurer") and the FIRST OF GEORGIA CREDIT LIFE COMPANY, Augusta, Georgia (hereinafter called the "Company").

WITNESSETH:

That in consideration of the mutual covenants hereinafter contained and upon the terms and conditions hereinbelow set forth, the parties hereto agree as follows:

ARTICLE I

APPLICATION OF AGREEMENT:

The Company will reinsure with the Reinsurer and the Reinsurer will accept reinsurance from the Company on the business described in certain Exhibits which are attached to and made a part of this Agreement and upon the terms and conditions set forth in said Exhibits.

ARTICLE II

LIABILITY OF REINSURER:

The liability of the Reinsurer shall follow that of the Company in every case and shall be subject in all respects to all the general and special stipulations, clauses, waivers and modifications of the Company's policy, binder or other undertaking and any endorsements thereon; and no error or omission in reporting any risk reinsured hereunder shall invalidate the liability of the Reinsurer, but the reporting of reinsurance not authorized by this Agreement or by special acceptance hereunder shall not bind the Reinsurer, except for the return of premiums paid therefor.

In the event of the insolvency of the Company, reinsurance hereunder shall be payable to the Company or the liquidator or receiver or statutory successor of such Company on the basis of the liability of the Company under the contract or contracts reinsured without diminution because of the insolvency of the Company, except as provided by law or except (a) where another payee of such reinsurance in the event of the insolvency of the Company is specifically designated and (b) where the Reinsurer, with the consent of the direct insured or insureds, has assumed such policy obligations of the Company as direct obligations of the Reinsurer to the payees under such policies and in substitution for the obligations of the Company to such payees. It is further agreed and understood that in the event of insolvency of the Company the liquidator or receiver or statutory successor of such Company shall give written notice to the Reinsurer of the pendency of a claim against the insolvent Company on the policy reinsured within a reasonable time after such claim is filed in the insolvency proceeding; that during the pendency of such claim the Reinsurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem available to the Company or its liquidator or receiver or statutory successor; that the expense thus in-

curred by the Reinsurer as the assuming insurer shall be chargeable subject to court approval against the insolvent Company as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the Company solely as a result of the defense undertaken by the Reinsurer as the assuming insurer.

ARTICLE III

CLAIMS:

All claims reported to the Company, which may involve the Reinsurer hereunder, shall be promptly reported by the Company to the Reinsurer, and the Company will also advise the Reinsurer of any subsequent developments likely to affect materially the interest of the Reinsurer in such claims.

Inadvertent omission or oversight by the Company in advising the Reinsurer of such claims and/or subsequent developments shall in no way affect the liability of the Reinsurer hereunder, provided such delayed advices be promptly dispatched to the Reinsurer as soon as the omission or oversight shall have been discovered by the Company.

The Company shall settle all claims in which this reinsurance may be interested and the same shall be binding upon the Reinsurer which shall be bound to pay or allow, as the case may be, its proportion of such settlements. The Reinsurer shall also bear its proportion of all expenses (excluding salaries of permanent officials and employees of the Company) connected with any resistance to or negotiations concerning settlement of such claim. It is understood that when so requested, the Company will afford the Reinsurer an opportunity to be associated with the Company at the expense of the Reinsurer in the defense or control of any claim or suit or proceeding involving this reinsurance, and the Company and the Reinsurer shall cooperate in every respect in the defense of such claim or suit or proceeding.

ARTICLE IV

RECOVERIES:

The Reinsurer shall be credited with recoveries (i.e., reimbursement obtained or recovery made by the Company, less the actual cost, excluding salaries of permanent officials and employees of the Company of obtaining such reimbursement or making such recovery) as follows:

(a) Where reinsurance hereunder is on the Share basis, the Company will credit the Reinsurer with its share of any recoveries on account of claims and settlements involving reinsurance hereunder.

(b) Where reinsurance hereunder is on the Excess Basis, recoveries applying to risks covered under this Agreement shall always be used to reimburse the excess carriers in the reverse order of their priority, according to their participation, before being used in any way to reimburse the Company for its primary loss.

ARTICLE V

REPORTS AND REMITTANCES:

The Company shall forward to the Reinsurer within twenty-one (21) days after the close of each calendar quarter, on forms mutually acceptable to the Company and to the Reinsurer, the following information relating to reinsurance covered under this Agreement during the said quarter:

- (a) Report of premiums;
- (b) Statement of claims paid and monies recovered;
- (c) Account Current summarizing the premiums, claims paid and monies recovered;

and the balance due either party, as indicated by the aforesaid Account Current shall be remitted by the other within forty-five (45) days after the close of said quarter.

Any loss chargeable to the Reinsurer that does not exceed One Thousand Dollars (\$1,000) shall be carried

to account for quarterly settlement as hereinbefore provided. Any loss in excess of One Thousand Dollars (\$1,000) shall either be carried to account or remitted by the Reinsurer to the Company, at the option of the latter, provided that the Reinsurer shall be entitled at its option to offset the amount of such loss against any balance or balances past due.

The Company shall also forward to the Reinsurer, on forms mutually acceptable to the Company and to the Reinsurer, the information set forth in any exhibits, which are attached to this Agreement.

ARTICLE VI

RESERVES AND TAXES:

The Company will furnish to the Reinsurer semi-annually a list of outstanding claims in which the Reinsurer is interested, showing the amount of loss reserves set up by the Company in respect of both the gross amount and the Reinsurer's share of each and every such claim.

The Company will be liable for all taxes and premiums reported to the Reinsurer hereunder.

ARTICLE VII

INSPECTION:

The Company shall place at the disposal of the Reinsurer at all reasonable times, and the Reinsurer shall have the right to inspect, through its authorized representatives, all books, records and papers of the Company in connection with any reinsurance hereunder or claims in connection herewith.

ARTICLE VIII

ARBITRATION:

If irreconcilable differences of opinion should arise as to the interpretation of this Agreement, the differences shall be submitted to arbitration, one arbitrator to be

chosen by the Reinsurer, one by the Company, and an umpire by the two arbitrators. The arbitrators and umpire shall be disinterested executive officers of insurance or reinsurance companies authorized to transact business in the United States. The arbitrators are relieved from all judicial formalities and may abstain from following the strict rule of law. They shall interpret this Agreement as an honorable engagement, and not merely as a legal obligation. The decision of the arbitrators shall be final and binding upon both parties but failing to agree they shall call in the umpire, and the decision of the majority shall be final and binding upon both parties. Each party shall bear the expense of its own arbitrator and shall jointly and equally bear with the other the expense of the umpire and of the arbitration. Any arbitration shall take place in such place as agreed upon by the arbitrators.

If either party fails to name its arbitrator within 30 days after receiving the written request of the other party to do so, the latter shall name both arbitrators and they shall select an umpire as stipulated herein.

ARTICLE IX

COMMENCEMENT and TERMINATION:

This Agreement shall take effect as of 11:59 P.M., Standard Time, December 31, 1961 and shall apply to all business of the Company in force at and/or becoming effective at and after that date and time. This Agreement is of unlimited duration but may be terminated as of Midnight, Standard Time, on the last day of March, June, September or December in any calendar year by either party giving to the other not less than ninety (90) days' notice by registered letter. The Reinsurer shall participate in business coming within the terms of this Agreement under binders, policies, cessions and certificates issued or renewed by the Company until the date of termination.

Unless otherwise mutually agreed, this Agreement shall remain in full force and effect on all business rein-

sured hereunder which became effective prior to the date of termination of this Agreement until expiration, cancellation or next anniversary date of such business, whichever occurs first.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed in duplicate this 31st day of December 1961.

FIRST OF GEORGIA INSURANCE COMPANY

/s/ Donald E. Tibbs
President

Attest: /s/ E. R. Phillips
Secretary

FIRST OF GEORGIA CREDIT LIFE COMPANY

/s/ Herbert S. Parks
Vice President

Attest: /s/ E. R. Phillips
Secretary

EXHIBIT A

QUOTA SHARE REINSURANCE OF
Accident and Health Insurance Business

Section 1

REINSURANCE COVERAGE

As respects the following classes of Accident and Health Insurance business the company will and does hereby reinsure with the reinsurer and the reinsurer will and does hereby accept a 60% quota share participation of the company's net liability under: (a) Individual Accident and Health Insurance business as classified by the company as that written through its agencies covered by the Industrial Loan Commission of the State of Georgia or similar business that the company may classify as the foregoing, (b) Policies of the company in force at and/or becoming effective on and after 11:59 p.m. December 31, 1961 (including renewals); it being understood that the remaining 40% of such net liability shall be retained by the company for its own account.

It is agreed that the Reinsurer's quota share participation in the liability of the company may be increased or decreased 10 percentage points by the Company giving to the Reinsurer not less than 30 days notice by registered letter such increase or decrease to be effective at the end or beginning of any calendar quarter. In such event the Reinsurer shall pay to the Company the unearned premiums which are applicable to the Reinsurer's decreased quota share participation, less the commission allowed thereon.

Section 2

SPECIFIC EXCLUSIONS

This Exhibit does not cover business accepted by the Company as reinsurance from other carriers.

Section 3

PREMIUM

As premium for the reinsurance afforded under this Exhibit, the Company will pay to the Reinsurer that percentage of the net premiums (i.e., gross premiums less cancellations and returns) written by the Company in respect of the classes covered hereunder which coincides with the Reinsurer's quota share participation in such business.

Section 4

LOSS EXPENSES

Notwithstanding anything to the contrary contained in Article III of this Agreement, the Reinsurer shall not be liable under this Exhibit for any loss expenses (both, allocated and unallocated).

Section 5

COMMISSION

No provisional coverage commission will be allowed on reinsurance premiums ceded, the final commission being determined on the basis of earned incurred loss experience in accordance with the following schedule. Where the earned incurred loss experience is zero, the commission will be 96% of the reinsurer's earned premiums; where the earned incurred loss ratio is 1%, the commission will be 95% of the reinsurer's earned premiums; the commission will slide point for point with the earned incurred loss ratio (i.e., for each point that the loss ratio increases the commission to the company will decrease a like point) so that the reinsurer's commission will remain constant at 4% of the reinsurer's earned premiums.

In the event that the reinsurer's earned incurred loss ratio equals or exceeds 96% for any quarter no commission will be due the Company and any deficit arising from such a determination shall be carried forward to subsequent quarterly commission determinations.

The first commission determination will be made according to experience for the term from January 1, 1962 thru March 31, 1962 and quarterly thereafter.

ENDORSEMENT No. 1

Attached to and made a part of
AGREEMENT No. 1

IT IS MUTUALLY AGREED, effective December 31, 1962, that the Reinsurers participation in Exhibit A is hereby increased from 60% to 70% and that said increased participation shall apply to all losses occurring on and after January 1, 1963.

In consideration of the foregoing the Company shall cede to the Reinsurer, as soon as possible after December 31, 1962, 25% of the Companys net unearned premium reserve under this Exhibit, on premiums in force as of December 31, 1962.

IT IS FURTHER AGREED that the Company shall retain net for its own account a quota share participation of 30% in respect of all business covered hereunder.

IN WITNESS WHEREOF, the parties hereto have caused this Endorsement to be executed in duplicate this 12th day of December, 1962.

FIRST OF GEORGIA INSURANCE COMPANY

/s/ [Illegible]
President

Attest: E. R. Phillips
Secretary

FIRST OF GEORGIA CREDIT LIFE COMPANY

/s/ Herbert S. Parks
Herbert S. Parks
Vice President

Attest: E. R. Phillips
Secretary

[PLAINTIFF'S EXHIBIT 23]

GEORGIA CREDIT LIFE INSURANCE COMPANY

REPORTED LOSSES ON CREDIT ACCIDENT
AND HEALTH AND CREDIT LIFE INSURANCE

FOR YEARS 1961 THRU 1964

	Accident and Health Insurance		Credit Life Insurance		Tax Return
	Individual	Group	Individual	Group	
1961	\$(22,050)*	\$none	\$72,370	\$5,200	\$ 55,520
1962	(24,973)*	266	70,709	7,418	53,420
1963	(33,535)*	35	97,297	838	64,636
1964	15,283	none	95,105	7,865	118,253

* Losses—The above information as to losses was extracted from the "Analysis of Operations by Lines of Business" which was included in the annual report to the State of Georgia for each year. See exhibits 14 thru 17 inclusive to the Stipulation of Facts.

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[GOVERNMENT'S EXHIBIT 2]

EXAMINERS HANDBOOK
NATIONAL ASSOCIATION
OF
INSURANCE COMMISSIONERS

EXAMINERS HANDBOOK

PART A

MANUAL OF ASSOCIATION EXAMINATION
PRACTICE AND PROCEDURE
SECOND EDITION 1951 REVISED
THIRD EDITION 1970 REVISED

Ref: 1961 NAIC Proceedings Vol. I pp. 123-145.

[A26]

EXAMINERS HANDBOOK

SECTION X

REINSURANCE CONTRACTS

I. PROGRAM FOR THE EXAMINATION OF FIRE AND CASUALTY REINSURANCE CEDED.

A. Reinsurance contracts should be read and workpaper notes prepared with respect to every contract on:

- (1) Type of contract, coverage, and limits.
- (2) Effective and expiration dates.
- (3) Cancellation provisions.
- (4) Reporting and settlement requirements.
- (5) Reinsurance premium rates.
- (6) Reinsurance commission rates to ceding insurer.
- (7) Insolvency clause.

B. Adequate test-check should be made of accounting transactions under the company's reinsurance contracts to establish their accuracy and to substantiate the balances due to and from reinsurers as of the date of examination, including premium and commission balances, funds withheld, and reinsurance recoverable on paid and unpaid losses.

C. If the company currently has, or has had, in effect the type of contracts discussed below in III, IV, or V and has not provided adequate liabilities in its financial statement with respect thereto, the examiner should establish such liabilities.

II. SPECIAL ATTENTION SHOULD BE GIVEN THE FOLLOWING:

A. Any provision for retroactive adjustment of reinsurance premium or commissions. In this

connection, complicated premium, commission, or settlement provisions when contained in any reinsurance contract, usually concern such retroactive provisions and should be fully explained by the ceding insurer or by the reinsurer and should be supported by the actual transactions under the reinsurance contract.

- B. Any commissions on reinsurance that may have been paid to or accepted, directly or indirectly, by *salaried* officers or employees of the insurer on whose behalf the reinsurance is placed.

III. LIABILITIES TO BE PROVIDED IN THE FINANCIAL STATEMENT WHEN THE REINSURANCE PREMIUMS OR COMMISSIONS ON REINSURANCE CEDED ARE ADJUSTABLE RETROACTIVELY ON THE BASIS OF LOSS EXPERIENCE.

- A. When the Company has received tentative reinsurance Commissions subject to retroactive adjustment on the basis of loss experience.
 - (1) Credit for reinsurance commission should be allowed, in any financial statement, only on reinsurance contracts which provide for indemnifications by the reinsurer of the ceding insurer, not only in form but in fact, against loss or liability by reason of the original insurance. Reinsurance contracts providing for tentative commissions based upon loss ratios and for a fixed fee to the reinsurer are considered as "surplus aid contracts" and considered as "surplus [A27] aid contracts" and not proper reinsurance since there exists, in fact, no indemnification for loss or liability to the ceding insurer on the original insurance. Tentative commissions should be fully reserved by a liability on the financial statement except to the extent earned without reference to estimated or projected loss ratios.

- (2) Full credit against the unearned premium reserve shall be given for that portion thereof ceded by reinsurance under a contract which contains the essential element of true reinsurance as defined in paragraph 1 hereof but provides for commission to the ceding insurer on a 'sliding scale' dependent upon the incurred loss ratios during an accounting period.

A ceding insurer may take credit in its annual statement for any reinsurance commission in excess of the minimum reinsurance commission guaranteed which has been earned under the provisions of the contract.

In the case of the ceding commission on the unearned premium reserve, credit shall be allowed for the minimum commission guaranteed and for any additional commission agreed upon subject to the following limitations:

- (a) The additional commission over the minimum guaranteed commission shall not exceed five per cent of the unearned reinsurance premiums.
- (b) The total commission shall not exceed that determined under the contract on the basis of the loss ratio, as of the financial statement date, on the business reinsured.
- (c) The total commission shall not exceed the average commission which would have been earned had the contract been in effect for the five years preceding the financial statement date or the portion thereof, during which the ceding company has been reinsuring business of similar classifications.

- B. When the Company has in effect any reinsurance contract providing for the retroactive adjustment of reinsurance premiums, it must be ascertained that an adequate reserve has been provided for any future adjustments.
 - C. When the Company has a continuing liability to a reinsurer with respect to losses recoverable under an expired contract such as covered in "A" and "B," an adequate liability should be provided therefor in the financial statement.
- IV. Subject to any necessary legislation, no credit should be granted for reinsurance commission, except to the extent actually earned, on reinsurance contracts which provide that the reinsurer is entitled to cancel such contracts on less than 90 days' notice, without providing for a runoff of the reinsurance in force at the date of the cancellation. If the ceding insurer has received reinsurance commission on the total amount ceded under any such contract, then in such an event, a liability must be set up in the financial statement for any reinsurance commission received in excess of the amount actually earned at the date of such financial statement.
- V. GENERAL RULES FOR ALLOWANCE OF BALANCES DUE FROM A REINSURER FOR UNEARNED PREMIUMS AND REINSURANCE RECOVERABLE ON PAID AND UNPAID LOSSES UNDER A CONTRACT FOR REINSURANCE CEDED.

Credit for these items can be allowed when:

- A. Adequate liabilities or reserves have been provided on any such contracts as are described in III, IV, or V.
- B. The reinsurer is a licensed insurer.
- C. The reinsurer is a regularly licensed domestic insurer of some other state, when the ceding

insurer can show that the reinsurer meets the [A28] same standards and financial requirements applicable to admitted insurers.

- D. At present, in most States, on account of reinsurance ceded to underwriters at Lloyd's, London.
- E. The reinsurer is a United States Branch of an alien reinsurer regularly admitted through the laws of some other State and subject to laws requiring it to maintain trusteed assets as security for its obligations in the United States.
- F. The reinsurance is with an otherwise unqualified alien or foreign reinsurer to the extent that the balances due from such reinsurer are absolutely secured by express provision therefor in the reinsurance contract by:
 - (1) funds withheld from the same reinsurer and under the exclusive control of the ceding insurer.
 - (2) securities on deposit and valued in accordance with valuation standards of the NAIC.
 - (3) funds held in trust in a bank that is a member of the Federal Reserve System and not subject to withdrawal without the consent of the ceding insurer.
- G. In some States, only if the reinsurance contract includes a proper insolvency clause, providing that in the event of insolvency of the ceding insurer, the reinsurer will remain fully liable for its share.
- H. Credit is not allowed for unearned reinsurance premiums when the reinsurance premiums are being paid by the ceding insurer on the basis of a percentage of the *earned* reinsurance premiums ceded. In the case of a

deposit premium paid to the reinsurer as in the case of loss or catastrophe reinsurance contract, except for the unused portion of such deposit, an additional liability must be set up if the reinsurance premiums due or accrued under the contract is in excess of such deposit.

VI. REPORT OF EXAMINATION

Under the caption, "Reinsurance," the examiners should set forth the company's reinsurance program in sufficient detail so as to permit the reader to evaluate it. All types of contracts, under which the company either cedes or assumes business, should be covered. The narrative should contain at least the following:

1. Types of contracts (quota share, excess of loss, etc.).
2. Line or lines covered.
3. Net retention and reinsurers limits.
4. Insolvency clause.
5. Premium rates and/or commissions need not be shown unless unusual or not in accordance with general practice.
6. Payments of the type referred to on page A26, Part II B.
7. Portfolio reinsurance during the last three months of any calendar year of the period should be fully explained.
8. If any contract does not meet the minimum requirement for a reinsurance contract established by the NAIC, the details of such a contract should be fully set forth.

Comment should be made on any reinsurance contract that contains any unusual features.

Where, in some states, due to statutory requirements, credit for reinsurance is not admitted in-

surers is not allowed, the report of examinations should state the amount thereof.

[A29]

VII. RE-INSURANCE

It is recommended that each examiner refer to the various reports of the Subcommittee to Study the Question of Reinsurance appearing in the Proceedings of the NAIC. The report, dated May 17, 1950, (1950 Proceedings P. 452) made by a Technical Subcommittee to the Subcommittee to Study the Question of Reinsurance, and the report of June 15, 1950 (1950 Proceedings P. 448) and amendments thereto of December 11, 1950, (1951 Proceedings P. 48) made by the latter subcommittee to the Executive Committee of the NAIC and any subsequent amendments are especially recommended. (Note: See Part B of this Handbook)

[A30]

SECTION XI

LIFE REINSURANCE CONTRACTS

Although most reinsurance agreements are designed primarily to transfer to a reinsurer, such risks as the company considers prudent, an occasional reinsurance agreement may be entered into with the purpose of substantially improving a ceding company's surplus, gain from operations, or both, with the intent to reimburse the reinsurer in the future. Frequently, such reinsurance agreements transfer no risk or essentially trivial amounts of risk relative to the reinsurance consideration. The intent of the following rules is to help identify these reinsurance agreements and to define under what conditions disclosure of the effect of the reinsurance on the ceding company should be made. These rules are of particular importance where questions of ceding company solvency are present.

1. Reinsurance agreements which contain any of the following elements shall be treated in the manner specified in 2, below.
 - (a) The agreement contains a provision which automatically terminates reinsurance, or which permits termination of reinsurance at the option of either company, with a predetermined retroactive adjustment that substantially eliminates all risk to the reinsurer.
 - (b) The agreement provides reinsurance premiums which are significantly excessive in relation to the risk ceded, either at inception of the agreement or after a deficit has been produced.
 - (c) The agreement provides an essentially trivial transfer of risk relative to the reinsurance consideration together with a significant increase in the ceding company's surplus and thus, the agreement essentially provides a loan to the ceding company even though it may appear to effect a transfer of risk.

(d) The agreement requires at the time of termination that the ceding company directly or indirectly reimburse the reinsurer entirely or substantially for any deficit accumulated while the agreement was in force.

2. Under the conditions described in 1, the report of examination should clearly explain the nature of such reinsurance agreements and the financial statements in the report should be appropriately footnoted, indicating the effect of such reinsurance agreements on the Summary of Operations and on the Surplus Account during the examination period and, to the extent possible, giving an indication of any significant effect of the agreements on the ceding company's future operations and stating any liability or contingent liability involved.
3. All reinsurance agreements which result in the ceding of a substantial portion of the company's previously retained renewal business should be carefully reviewed to determine the over-all effect. Such review should include a history of these reinsurance agreements and the effect on the ceding company of these reinsurance agreements, including the effects on surplus and the Summary of Operations.

[A31]

4. Reinsurance agreements of any type between a company and its parent, affiliates or subsidiaries shall be reviewed to insure that the terms in fact constitute an "arms length" agreement.
5. If the effect on the surplus of the ceding company is such that the ceding company without benefit of the reinsurance agreements described in 1 and 2, would not meet the minimum requirements for capital and/or surplus of its state of domicile or of any state in which it is licensed to transact business, the situation should be clearly explained in the report of examination and the financial statements in the report should be footnoted to indicate the effects of the reinsurance agreements.

EXAMINERS HANDBOOK
NATIONAL ASSOCIATION
OF
INSURANCE COMMISSIONERS

EXAMINERS HANDBOOK

PART B pages B1-B31

REINSURANCE SUBCOMMITTEE REPORTS
AS AMENDED

[B3] REINSURANCE SUBCOMMITTEE REPORTS

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Subcommittee—To Study the Question of Reinsurance

EXCERPT from—Report 6-15-50

Your Subcommittee to Study the Question of Reinsurance held further meetings on Saturday, June 10, 1950, and Thursday, June 15, 1950, at Chateau Frontenac, Quebec, Canada, with all Subcommittee members present. These meetings were open to the public and a considerable number of representatives of professional reinsurers and the insurance industry were present. (Ref: 1950 Proc. p. 448)

The report made to your Subcommittee by its technicians dated May 17, 1950, a copy of which is attached hereto and made a part hereof, was fully discussed and considered by both the members of your Subcommittee and the industry representatives present and received general favorable comment from the latter. On the basis thereof, the following conclusions have been reached by your Subcommittee and are respectfully recommended for adoption as the policy of your committee and the National Association of Insurance Commissioners. (Ref: 1950 Proc. pp. 448-449.)

1. The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer, not only in form but in fact, against loss or liability by reason of the original insurance. Unless the so-called reinsurance contract contains this essential element, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer. (as amended 1951 Proc. p. 48)

Refs: 1950 Proc. p. 449

1951 Proc. p. 48 amended

2. Credit in accounting and financial statements on account of reinsurance ceded should be based upon actual value of the reinsurance and the security underlying its collectibility and not upon the license status of the reinsurer. Laws which restrict

credit for reinsurance ceded to admitted insurers only, should be amended to comply with the principles set forth in this report. (as amended 1951 Proc. p. 48)

Refs: 1950 Proc. p. 449

1951 Proc. p. 48 amended

3. No credit in accounting and financial statements on account of reinsurance ceded shall be allowed unless the reinsurance contract contains a proper insolvency clause. The recommended form of such a clause is attached to this report. (as amended 1951 Proc. p. 49)

Refs: 1950 Proc. p. 449

1951 Proc. p. 49 amended.

4. Credit in accounting and financial statements on account of reinsurance ceded to a non-admitted reinsurer other than an alien reinsurer shall be allowed (a) where it is demonstrated by the ceding insurer to the satisfaction of the Commissioner that such reinsurer maintains the same standards and meets the same financial requirements applicable to an admitted insurer, or (b) to the extent of deposits by or funds withheld from such reinsurer pursuant to express provisions therefor in the reinsurance contract as security for the payment of the obligations thereunder if such deposits or funds are held subject to withdrawal by, and under the control of, the ceding insurer or are placed in trust for such purposes in a bank which is a member of the Federal Reserve System if withdrawals from such trust cannot be made without the consent of the ceding insurer. (as amended 1951 Proc. p. 49)

Refs: 1950 Proc. p. 449

1951 Proc. p. 49 amended

5. Credit in financial statements on account of reinsurance ceded to an alien reinsurer shall be allowed only to the extent of the amount of deposits

by and funds withheld from such alien reinsurer pursuant to express provision therefor in the reinsurance contract or in a supplemental written agreement as security for payment of the obligations thereunder if such deposits or funds are held subject to withdrawal by, and under the control of the ceding insurer or are placed in trust for such purposes in a bank which is a member of the Federal Reserve System if withdrawals from such trust cannot be made without the consent of the ceding insurer. As used herein, "alien reinsurer" does not include the United States Branch of an alien insurer which is subject to laws [B7] requiring it to maintain on deposit in the United States trusted assets as security for its obligations in the United States. (as amended 1952 Proc. p. 413)

Refs: 1950 Proc. p. 449

1951 Proc. p. 49, amended

1952 Proc. p. 186, amended—Lloyds London exemption deleted

1952 Proc. p. 191, Lloyds London effective date for compliance 12/31/52

1952 Proc. p. 412, Lloyds London effective date for compliance postponed to 12/31/53

1952 Proc. p. 413 amended—provided for supplemental agreement

1953 Proc. VOL. II, p. 436, Lloyds London effective date for compliance postponed to 12/31/54

1954 Proc. VOL. II, pp. 415-416, Lloyds London—question of compliance remanded to States.

6. Deposits and funds withheld under reinsurance treaties shall be reported on the asset side of the financial statement of the ceding insurer, sepa-

rately from other assets, supported by a detailed schedule describing the deposits or securities in which the withheld funds are invested, and such deposits and securities shall be valued only in accordance with the valuation standards of the N.A.I.C. for assets of insurers. Such schedule need not allocate such deposits or securities to the accounts of specific reinsurers or reinsurances. (as amended 1951 Proc. pp. 49-50)

Refs: 1950 Proc. p. 450

1951 Proc. pp. 49-50—amended

7. Full credit against the unearned premium reserve shall be given for that portion thereof ceded by reinsurance under a contract which contains the essential element of true reinsurance as defined in paragraph 1 hereof but provides for commission to the ceding insurer on a 'sliding scale' dependent upon the incurred loss ratio during an accounting period.

A ceding insurer may take credit in its annual statement for any reinsurance commission in excess of the minimum reinsurance commission guaranteed which has been earned under the provisions of the contract.

In the case of the ceding commission on the unearned premium reserve, credit shall be allowed for the minimum commission guaranteed and for any additional commission agreed upon subject to the following limitations:

- (a) The additional commission over the minimum guaranteed commission shall not exceed five per cent of the unearned reinsurance premiums.
- (b) The total commission shall not exceed that determined under the contract on the basis of the loss ratio, as of the financial statement date, on the business reinsured.

- (c) The total commission shall not exceed the average commission which would have been earned had the contract been in effect for the five years preceding the financial statement date or the portion thereof, during which the ceding company has been reinsuring business of similar classifications. (as amended 1952 Proc. pp. 406-411)

Refs: 1950 Proc. p. 450

1951 Proc. p. 50 amended

1952 Proc. pp. 406-411 amended

8. Where under the terms of a reinsurance contract the reinsurer is entitled to cancel such contract on less than ninety days' notice, without providing for a runoff of the reinsurance in force at the date of cancellation, credit for commission shall be allowed to the ceding insurer only as and to the extent that such commission is actually earned. In the case of a reinsurance contract requiring ninety or more days' notice of cancellation and involving reinsurance of more than twenty per cent of the ceding insurer's gross unearned premiums before any deduction for such reinsurance, the ceding insurer, within thirty days after receiving notice of cancellation, shall notify the Commissioner of each state in which it is authorized to do business of the fact of cancellation and the estimated amount of gross unearned premiums and return commissions involved. (as amended 1951 Proc. p. 50)

Refs: 1950 Proc. p. 450

1951 Proc. p. 50 amended

[B8]

9. Commissions on reinsurance ceded shall not be paid to or accepted by, directly or indirectly, salaried officers or employees of the insurer on whose behalf the reinsurance is placed. This provision shall not apply to dividends received by any such officer or employee upon the stock of a corporation

in which such officer or employee and his immediate family do not own a controlling interest or in fact exercise control. (as amended 1951 Proc. p. 50)

Refs: 1950 Proc. p. 450

1951 Proc. p. 50 amended

Recommended

INSOLVENCY CLAUSE

The reinsurance shall be payable by the reinsurer on the basis of the liability of the ceding insurer under the contract or contracts reinsured without diminution because of the insolvency of the ceding insurer. In the event of the insolvency and the appointment of a liquidator, receiver or statutory successor of the ceding company, such portion shall be payable to such liquidator, receiver or statutory successor immediately upon demand, with reasonable provision for verification on the basis of claims allowed against the insolvent company by any court of competent jurisdiction or by any liquidator, receiver or statutory successor of the company having authority to allow such claims, without diminution because of such insolvency or because such liquidator or statutory successor has failed to pay all or a portion of any claims. Payments by the reinsurer as above set forth shall be made directly to the ceding insurer or to its liquidator, receiver or statutory successor, except where the contract of insurance or reinsurance specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer and where the reinsurer with the consent of the direct insured or insureds has assumed the policy obligations of the ceding insurer as direct obligations of the assuming company to the obligees under such policies and in substitution for the obligations of the ceding insurer to such obligees.

The reinsurance agreements may provide that the liquidator, receiver or statutory successor of a ceding insurer shall give written notice of the pendency of a claim

against the ceding insurer indicating the policy or bond reinsured, within a reasonable time after such claim is filed and the reinsurer may interpose, at its own expense, in the proceeding where such claim is to be adjudicated, any defense or defenses which it may deem available to the ceding company or its statutory successor. The expense thus incurred by the reinsurer shall be payable subject to court approval out of the estate of the insolvent ceding insurer as part of the expense of liquidation or receivership to the extent of a proportionate share of the benefit which may accrue to the ceding insurer in liquidation or receivership, solely as a result of the defense undertaken by the reinsurer.

The original insured or policyholder shall not have any rights against the reinsurer which are not specifically set forth in the contract of reinsurance. (1951 Proc. p. 51)

Refs: 1950 Proc. pp. 451-452
1951 Proc. p. 51

Lincoln, Nebraska
May 17, 1950

Members of the Subcommittee to Study the
Question of Reinsurance (N.A.I.C.):

Hon. Wallace K. Downey,
Chairman
Insurance Commissioner
San Francisco, California

Hon. Charles F. J. Harrington
Commissioner of Insurance
Boston, Massachusetts

Hon. Sterling Alexander,
Commissioner of Insurance
Des Moines, Iowa

Hon. Bernard R. Stone
Director of Insurance
Lincoln, Nebraska

Gentlemen:

On December 3, 1949, your Subcommittee adopted a resolution suggesting that a subcommittee of technicians study the question of Fire and Casualty reinsurance with particular regard to the seven (7) points enumerated in said resolution, as follows:

[B9] 1. The question of allowance of credit on financial statements of insurers for non-admitted reinsurance.

2. The question of allowance of credit on financial statements of insurers for alien reinsurance.

3. The question of allowance of credit on financial statements for reinsurance, when the reinsurer is not bound to carry the risk for any fixed term, but is free to terminate the reinsurance at will or on very short notice.

4. The question presented by reinsurance contracts providing for a sliding scale of commission to the ceding insurer, when the time for settlement and arrival at the fixed commission is at a future date.

5. The question of commissions paid to brokers for obtaining reinsurance for insurers when such brokers or brokerage concerns are owned by officers or employees of such insurers and when they collect commissions for obtaining such reinsurance when their services appear to be of little or no value.

6. The question of whether in making examination of insurers more information should not be developed with reference to reinsurance contracts and such information set forth in examination reports.

7. The question whether it would not be well to request the Blanks Committee to amend the annual statement blank form in order to allow those who analyze annual statements of insurers to determine if an insurer has attempted to aid its surplus in an unwarranted manner by the device of reinsurance.

The outline of the report follows the seven (7) points stated in the resolution of the Subcommittee. Following the report will be found an appendix on the general subject of reinsurance, including definitions, a brief history of reinsurance, comments on the volume of reinsurance written, a discussion of various usual types of reinsurance contracts, and a brief discussion of treaty reporting methods, together with a summary of present reinsurance state laws and practices.

I. The Question of Allowance of Credit on Financial Statements of Insurers for Non-Admitted Reinsurance.

Because of the divergence of laws between the various states with respect to reinsurance ceded to non-admitted

companies, it is possible for an insurer to be considered solvent in one state and at the same time be considered insolvent under the laws of another state. Some states prescribe no tests for measuring the value of ceded reinsurance; other states make ability of the reinsurer to perform its contracts as the sole test of value; while other states make admission of the reinsurer in the state a condition precedent to the allowance of reinsurance credits, regardless of whether or not the reinsurer is financially sound. These differences are basic and reflect upon the efficacy of state regulation of insurance business.

All of the states have set up elaborate and fairly uniform regulatory systems governing the operations of insurance companies operating therein. Such companies are regulated with respect to the character of their assets, their methods of accounting and reporting, the reserves which they are required to maintain, and many other phases of their business. This has been deemed necessary to promote the safety, welfare, and protection of the insuring public. Companies issuing policies of insurance are required to maintain certain standards of solvency and be able to fulfill their contract obligations upon the happening of any hazard insured against. The regulation of reinsurance, however, although equally important, seems to have been neglected in many jurisdictions. It is obviously illogical to scrutinize closely certain assets and liabilities included in the financial statements of admitted insurers and at the same time permit those statements to be affected in a major way by credits on account of reinsurance transactions with companies concerning which almost nothing may be known, especially when the amounts claimed may be of doubtful collectibility.

Properly managed insurance companies endeavor to protect themselves and their policyholders by reinsurances and retrocessions. The actual value of that protection cannot be determined on the arbitrary basis of whether or not the reinsurer is licensed in a particular state. If the reinsurer can furnish competent evidence of its solvency; if it can prove that it maintains the same standards and solvent condition as the state requires of

like companies seeking admission therein, there seems to be no valid reason (other than state law) why the ceding company should not be permitted to take credit for such reinsurance.

[B10] Disallowance of credits on all cessions to unlicensed companies would simplify the task of an insurance department; however, if every state did likewise, it would be impossible to produce a financial statement that would be generally acceptable, and the task of the insurance companies would be monumental. Since the real object of state regulation is to protect the policyholder and not to penalize non-admitted reinsurers, there should be an effort to minimize the importance of admittance as a measure of the value of reinsurance credits.

Practically all jurisdictions allow credits for reinsurance ceded up to the amount of funds withheld from, or due to, the reinsurer, if such funds are held subject to withdrawal by, and under the control of, the ceding company. Some states, including Massachusetts and New York, acquire the necessary information through "funds withheld" statements prepared by the ceding companies.

It appears essential that the regulatory authority be clothed with discretion with respect to allowing credit for reinsurance in non-admitted American companies, particularly with respect to reinsurance in states which do not exercise reasonable control over reinsurance and retrocessions. Care should be taken to avoid credit for large reinsurances placed with insurers of minor financial responsibility, which then, by retrocession, become mere conduits for the placing of large premium volumes in unacceptable reinsurers, a practice sometimes called "flying a kite."

It is conceded that only the Legislature can amend or repeal existing state laws. It is interesting to note, however, the trend toward a more realistic approach to the problem by the Legislatures of many states. New York has lodged discretionary power in the Superintendent of Insurance to value reinsurance credits on the basis of actual conditions. Nebraska, California, Oregon and a few other states have placed the burden of determining actual

value of claimed reinsurance on the Commissioner. Such Commissioners will no doubt require the ceding company to show by competent evidence the value of its ceded reinsurance.

Results of Questionnaire

To determine what are the present laws and practices of the various states with respect to non-admitted reinsurance has been one of the purposes of the present survey. A questionnaire on the subject was mailed to the state insurance departments of the several states and territories and to a number of Canadian provinces. Responses were received from forty-six states and territories and from five Canadian provinces and the Dominion office.

It is interesting to note that many of the states having laws that deny reserve credits for, or forbid reinsurance to, non-admitted companies, construe their laws as applicable only to the reinsurance of risks on property located within that particular state. Such states ordinarily follow the rule of the state of domicile of a foreign company with reference to reinsurance cessions covering risks located in other states. A few states construe their laws as applicable only to domestic companies.

Some states, including Massachusetts, New York, Ohio and Iowa, apply the restrictions nation-wide. Section 70 of the New York Insurance Code provides that the Superintendent may, by official regulation, prescribe the conditions under which a ceding company may be allowed credit as an asset or as a deduction from loss and unearned premium reserves, for reinsurance recoverable from a non-admitted reinsurer which presents satisfactory evidence that it meets the applicable standards of solvency required for admission to the state.

A number of states permit credits against unearned premium and loss reserves on cessions to non-admitted companies if the non-admitted reinsurer is admitted in at least one or more states or territories of the United States and maintains the same conditions of solvency as are required of admitted companies.

A number of states admit credits on cessions to unlicensed alien carriers when such alien reinsurer is admitted by and maintains certain deposits in one or more states or territories of the United States.

II. *The Question of Allowance of Credit on Financial Statements of Insurers for Alien Reinsurance.*

Considerable economic benefit can be, and has been in the past, derived from the international distribution of risk through the facilities of alien reinsurance. Unfortunately, such interchange has been greatly hampered in recent years by disturbed world conditions and related factors.

[B11] Insurers must not only adjust themselves to violently fluctuating exchange values but they must reckon with currency restrictions imposed by the various national governments. The list of nations having entirely free exchange changes from day to day. As of February 15, 1950, the list was limited to four nations—the United States, Switzerland, Thailand, and Venezuela. Some nations, such as Great Britain, ordinarily permit the transfer of reinsurance funds.

As an aftermath of World War II, the insurance business in some countries has been left in an unstable condition. Lack of knowledge concerning regulatory standards in certain foreign jurisdictions has further added to the general uncertainty. Even under normal circumstances, an analysis of the financial statement of the average non-admitted alien insurer is meaningless to the American regulatory official as he cannot determine whether the statement contains assets which would be inadmissible in the United State and whether reserves and liabilities are set up in a manner comparable with American standards.

These complications do not exist with respect to the United States branches of alien insurers, which are required to deposit with trustees qualifying securities and operate according to, and meet the strict standards of, the states through which they are admitted. Reinsurance ceded to such insurers is fully as safe and collectible as that placed with established American reinsurers.

One method of protecting the interests of the American policyholder is to require a trust deposit in the United States of an amount of admissible securities, exceeding by a reasonable margin the amount of American obligations of the alien reinsurer, together with suitable provisions for the reporting to some American regulatory agency the amounts so held and the amounts of the American liabilities of the alien reinsurer. Maintenance of unsupervised general deposits in the United States may not suffice because such deposits can be, and have been, withdrawn prior to attachment to satisfy claims.

The most obvious answer to the problem of non-admitted alien reinsurance appears to be by the limitation, such as now imposed under the laws of Massachusetts, New York and some other states, whereby credit for alien reinsurance is allowed only to the extent that the premium thereon, plus the commission, is held in trust or withheld by the ceding insurer (subject to suitable regulations) until such time as all or a portion of the premium is earned, the losses paid, and the resulting profit or loss to the reinsurer determined. The unsecured obligation of the reinsurer is determined by means of an appropriate "statement of funds withheld."

This procedure is suggested by the general practice of European insurance companies when dealing with each other. During the period following World War I, European reinsurance practices were changed to allow the ceding company to withhold from the reinsurer such sums as were approximately equal to the unearned premium reserves on the reinsurance ceded, the usual withholding being 40% of the annual premiums credited to the reinsurer. This practice is almost universal on the continent, and in some cases has been extended to permit the ceding company to withhold additional funds equal to the estimated amount of reinsurance recoverable on paid and unpaid losses. Since the unearned premium reserve withheld is the property of the reinsurer, nominal interest is usually paid by the ceding company.

Withholding or deposit requirements occasionally necessitate the actual remittance of funds from the reinsurer to the ceding company at inception. Sometimes provision

is made for the deposit of securities by the reinsurer in lieu of the withholding of cash.

Withholding is purely a precautionary measure and implies no reflection on the reinsurer. It provides protection to the ceding company not only against possible insolvency of the reinsurer but against the possibility of loss arising through war or other international disturbance that might cause heavy losses of balances due from reinsurers located in other countries.

Lloyd's London

Lloyd's London differs from other alien reinsurers because of its relative familiarity to American insurers and regulatory officials and because of its long and favorable record. This organization, as is well known, is not an insurance company, but an organization of approximately 2,400 "Name" underwriters, who, severally, and each for himself, as members of various underwriting syndicates, write large mounts of marine and non-marine insurance, including substantial amounts of American excess of loss reinsurance. Business must be placed through a Lloyd's broker. The writing of [B12] insurance is on a comparatively free and untrammelled basis insofar as coverage and rate are concerned, but is under the general direction of the "Committee of Lloyd's," consisting of twelve members.

On August 26, 1939, members of the Committee of Lloyd's executed a number of trust deeds, each pertaining to "a Name whose Agent has made such request," whereby the American Trust Fund was established. The Committee exercised its power to amend certain trusts and provisions of the several trust deeds on October 31, 1947, and January 14, 1948. As of December 31, 1949, the Lloyd's American Trust Fund amounted to \$246,367,-495.65, consisting of Cash 69.10%, U. S. Government Securities 27.79%, and Miscellaneous Other Securities 3.11%, as confirmed by the City Bank Farmers Trust Company, of New York City, as American Trustee. It is provided that the Committee shall not exercise its powers to revoke the American Trust Fund at any time prior to December 31, 1967.

The American Trust Fund of each "Name" consists of all premiums and other moneys payable to the "Name" in connection with American business. The funds are available exclusively for the payment of losses, claims, return premiums, certain expenses, and amounts in excess of the necessary liabilities in respect to American business as determined by auditors approved by the Committee.

It is provided that the claim of a policyholder against the American Trust Fund of a "Name" shall become enforceable after the expiration of a 30 day period after the filing with the American Trustee of a certified copy of a judgment obtained by the policyholder in any court of competent jurisdiction within the United States against the "Name" in respect of the "Name's" liability under a policy, and after such judgment has become final and the time for appeal has passed. Such a judgment shall be satisfied by the American Trustee out of the American Trust Fund of the "Name" against whom such judgment has been obtained without regard to the rights of the other policyholders.

Nothing contained within the agreement shall constitute any partnership between any of the "Names," the underwriting business of each of them being carried on for his own sole and separate account. No information is publicly available as to the amounts credited to, or carried in trust for, each of the "Name" underwriters.

The provisions of the schedule in respect to the American Trust Fund and the rights thereby conferred are governed by the Law of the State of New York. But "the Trust Deeds shall continue to be governed by and the rights of all parties in respect to the Trust Fund thereunder by the Law of England."

Lloyd's London is admitted to do business in the States of Illinois and Kentucky. In the Commonwealth of Massachusetts reinsurance with Lloyd's, London, is allowed under the provisions of special legislation.

General Suggestions Concerning Lloyd's

It would appear that Underwriters at Lloyd's, London, might risk placing themselves in the same position as other non-admitted alien reinsurers in the eyes of American regulatory authorities unless certain steps are taken. Suggestions follow:

(1) Some definite provision to be made to assure the availability of assets in the American Trust Fund for the payment of liabilities in the United States regardless of the individual "Names" to which such funds belong. The method of accounting between "Names" and the method of reimbursement that might be made in England between the "Names" is a matter of no particular moment to a ceding company that has large claims against certain Lloyd's Underwriters. There appears no basic reason why such assurance cannot be made without disturbing the present method of doing business with respect to negotiating business or establishing reinsurance rates. It would appear to do no more than put on paper a matter that has long been a matter of custom and honor with Lloyd's—that no insurer or reinsurer should suffer loss through the insolvency of an Underwriter, or Underwriters, at Lloyd's.

(2) Provision be made for designating the various Insurance Commissioners as attorneys for service.

(3) Some method be adopted for relating the amount of assets in the American Trust Fund with the liabilities in the United States of Underwriters at Lloyd's, in such a manner as can be established to the satisfaction of the regulatory authorities.

[B13] III. *The Question of Allowance of Credit on Financial Statements for Reinsurance, When the Reinsurer Is Not Bound to Carry the Risk for Any Fixed Term, But Is Free to Terminate the Reinsurance at Will or on Very Short Notice*

Most reinsurance contracts, other than "spread loss," are cancellable by either party upon 60 to 90 days written notice, which is intended to allow the ceding company adequate time to negotiate a new reinsurance con-

tract. Provision is usually made in the reinsurance contract for the runoff of covered risks or payment of return premiums in the event of termination. Such cancellation by the reinsurer is not likely to leave the ceding company without adequate reinsurance facilities unless the quality of the business is such as to make it an undesirable risk.

The early cancellation of a contract may imply that it was not entered into with the bona fide intention to reinsure, but to temporarily increase the surplus of the ceding company. Examinations of companies have disclosed instances of reinsurance treaties negotiated at the year-end, and cancelled shortly thereafter. The remedial action in such cases appears to be greater vigilance on the part of examiners and bureaus of financial analysis in detecting such instances. The proposed Schedule "F," described in part VII, would help supply the necessary information. Return commission reserves should be established to nullify the beneficial surplus effect of reinsurance cessions which are determined to be mere "window-dressing" transactions.

There is nothing basically wrong with the right to cancel. Any legislative interference with the rights of contracting parties to provide cancellation clauses in their contracts would appear to be detrimental to the best interests of the insurance business.

IV. *The Question Presented by Reinsurance Contracts Providing for a Sliding Scale of Commission to the Ceding Insurer. When the Time for Settlement and Arrival at the Fixed Commission Is at a Future Date.*

The following comments are not primarily concerned with the currently popular form of "sliding scale" reinsurance contracts, nor with the type that provides for an initial flat commission to be subsequently increased by profit commissions. Comments are confined principally to those contracts which do not transfer any risk, but are used merely to create an apparent increase in the surplus of the ceding company. Consideration of this question requires an inquiry into the following subjects:

American requirements for an unearned premium reserve on a gross basis without deduction for acquisition costs, the normal effect on the surplus of the ceding company of the cession of reinsurance, and the effect on surplus of the ceding company of the various types of surplus aid contracts.

*American Gross Unearned Premium Reserve
Requirements*

It has long been the practice in most states to require insurers to set up as a liability the gross amount of unearned premiums in force. This is required not only by the Annual Statement blanks distributed by the several states, but in many states by statute. About the only exceptions are certain types of mutual companies, usually doing a purely intrastate business, where the reserve requirement may vary from 0% to 100% of the unearned premiums in force, dependent on the assessment liability provided in the policy.

It has been stated that the purpose of an unearned premium reserve on a fire or casualty company's financial statement is to provide for the payment of return premiums to policyholders in case of cancellation, or to reinsure the business with some other insurance company if the need should arise. Even more important is the fact that future claims and expenses to be incurred on this business necessitates the existence of such a liability. The basic reason is simply that it is proper accounting practice to establish a liability for income received but not yet earned.

Insurance acquisition costs are usually paid in advance by the insurer. The several states, however, permit no reduction of the unearned premium reserve on account of such prepayment, nor are acquisition costs applicable to the unearned portion of the premium permitted to be carried as an asset in the form of a deferred charge. The effect is to make acquisition expense a direct burden on surplus. This burden is particularly heavy in times of business expansion. The requirement that there be maintained an unearned premium reserve

is frequently looked upon as the source of this financial burden. In reality, it arises out of the prepayment of acquisition costs.

[B14] Although it is a fully recognized fact that the procedure in the United States with respect to setting up an unearned premium reserve equal to 100% of such unearned premiums, without credit for acquisition costs, sometimes results in the establishment of hidden reserves in the guise of unearned reserves. There are arguments in favor of this practice. The heavy charge to surplus for such acquisition costs sometimes prevents the ambitions of over rapid expansion of a company that might well result in its ultimate insolvency. It further imposes, in an indirect manner, additional capital requirements on companies having large amounts of business in force. American statutory capital requirements, as such, are rigid and do not impose increased capital requirements on companies doing a large volume of business.

*Normal Effect Produced on the Unearned Premium
Reserve Surplus of the Ceding Company by the
Cession of Reinsurance*

An insurer may properly reduce the burden upon surplus by the reinsurance of a portion of its business in a manner which transfers a part of its risk to another insurer.

Most facultative contracts, surplus or share treaties, quota share treaties, portfolio contracts, and other pro rata reinsurance types, as well as many casualty excess of loss reinsurance treaties, provide for runoff of covered risks or return of the unearned reinsurance premiums in the event of termination of the reinsurance treaty. Such reinsurances may, therefore, have a decided effect on the premiums in force and on unearned premium reserve, not only at the time the reinsurance premiums are written, but thereafter until termination.

The effect on the unearned premium and surplus of the ceding company by the cession of reinsurance is almost the same as that produced by the expiration or

cancellation of direct business, i.e., a reduction in the unearned premium reserve and an increase as in the surplus of the premiums are earned, or the "equity" is released. In the case of reinsurance ceded, the immediate increase in surplus is equal to the amount of reinsurance commissions received.

The effect on the reinsurer is the opposite, i.e., reinsurance accepted increases the premiums in force and the unearned premium reserve, and immediately reduces surplus by the amount of commission paid. The effect is similar to that produced by the writing of direct business.

The transfer of the gross unearned premium reserve from the ceding company to the reinsurer, and the transfer of surplus from the reinsurer to the ceding company, are eminently proper because the exposure to risk on the part of the ceding company has ceased with respect to the reinsurance ceded, and the exposure to that same risk on the part of the reinsurer has commenced, in direct proportion to the amount of reinsurance premiums ceded.

Surplus Aid Contracts

Surplus aid contracts have the same apparent immediate effect on the ceding company's unearned premium reserve and surplus as the usual cession of reinsurance. There is one important difference. The surplus aid contract does not result in the transfer to the reinsurer of the corresponding risk or liability—which is the main characteristic of a legitimate reinsurance transaction.

Such surplus transfer is valid only where, in actuality, risk has been transferred to the reinsurer, and the ceding insurer has been relieved of a corresponding portion of the liability for insurance service not yet rendered but for which it has been paid.

It is difficult to view this type of contract as anything other than a device to create fictitious capital. If such contracts are recognized, the capital increase, however fictitious, is given credit by the regulating authority on a parity with the company's tangible assets. It appears

that some uniform bar against credit for transactions of this type is necessary unless the general plan for the regulation of insurers is to become meaningless to a great extent.

Guaranteed Profit Contracts

The most common form of "surplus aid" is the "guaranteed profit" contract. Its principal characteristic is that it transfers unearned premium reserve from the ceding company to the reinsurer and results in an immediate increase in the ceding company's surplus by the amount of tentative commissions received, but because all such tentative [B15] commissions are subject to return to the reinsurer, does not actually relieve the ceding company of risk. The ceding company still remains exposed to the same risk as before. It is in the position of paying two to five percent of the ceded premiums to induce a reinsurer to sign a contract which has no ultimate effect, other than to reduce its surplus by two to five per cent of these premiums.

There is considerable doubt as to whether any of the guaranteed profit contracts can be properly described as "reinsurance" in view of the available definitions of reinsurance. It appears, however, that some guaranteed profit contracts contain at least an implied limit to refunds from the ceding company equal to the amount of tentative commissions originally paid. To this extent there may be a slight element of risk-taking on the part of the reinsurer. If the loss ratio ran over 100%, the reinsurer would then become liable for such losses. This is a remote possibility and is largely of academic interest.

Guaranteed profit contracts are often written in a form similar to a quota share or portfolio reinsurance contract, or a combination of both. The tentative commission is ordinarily 45 or 50 per cent. The reinsurer's fee is generally 2, 3, or 5 per cent of the amount ceded. Most quota-share type contracts are subject to monthly reporting and settlements. The contract usually provides for additional commissions to be increased by 1 per cent for each 1 per cent decrease in the loss ratio, and

return commissions on the basis of 1 per cent for each 1 per cent increase in the loss ratio.

An example follows:

Commission	45%
Fee for reinsurer	3%
Loss ratio "breaking point"	52%
Total original premium	100%

In a situation similar to the one illustrated, the ceding company pays to the reinsurer the gross reinsurance premiums less 45% commissions, a net of 55%. As losses are determined, they are paid by the reinsurer until the ceding company has received back from the reinsurer losses recovered in an aggregate amount equal to 52% of the original premiums ceded (55% less 3%). Any additional losses are immediately charged back to the ceding company as "return commissions" on a "1 for 1" basis. On the other hand, any saving under 52% is returned to the ceding company in the form of additional commissions. The ultimate effect on the ceding company is the loss of 3% of its ceded premiums. The ceding company actually carries its own full risk throughout the entire period with respect to its gross business.

Although guaranteed profit contracts usually are written to cover no more than 10 to 50 percent of the business of a ceding company, an observation can be made that theoretically a company could write an enormous volume of business and cede 100 per cent of such business on a guaranteed profit basis unless prevented from doing so by law or administrative decision. Its financial statement would show no unearned premium reserve whatsoever. It would have succeeded in taking into its surplus immediately, through the tentative reinsurance commission received, not only the full recovery of its acquisition costs and anticipated profit hoped to be earned on the business, but perhaps also amounts ultimately needed to pay losses and expenses.

Companies which write too much business in proportion to their surplus frequently are optimistic as to the future profit to be derived from such business and prefer to retain as much of the risk as possible in one way or

another. A guaranteed profit contract may appear attractive to such company. Before resorting to a contract of this type, a company should consider the obvious alternatives. One alternative is to slow up new writings, even though such a step may result in some damage to an agency plant previously built up at considerable expense. Another is to raise additional capital through the sale of stock or the issuance of contribution certificates. Another method is the cession of more business through legitimate reinsurance contracts. When the business lacks stability, even quota-share reinsuring a portion of the business may prove beneficial until greater stability and capacity have been developed.

In some cases companies have used guaranteed profit contracts temporarily to aid their surpluses until premium volume leveled off, and the relation between written and unearned premiums became more stable. There is, however, an element of risk that can adversely affect the interest of the company's policyholders. One recent case was noted in which a large company in financial difficulties resorted to a guaranteed profit contract and subsequently had to repay to the reinsurer in the form of "return commissions" an amount in excess of \$535,000. This company did not work its way out of its difficulties but had to be salvaged by other means.

[B16] The use of guaranteed profit contracts became fairly common during the period of sharp increases in premium volume caused by inflation and an increased demand for insurance during the years 1946, 1947, and 1948. Since that time their use appears to have considerably subsided. The idea of such contracts is not new. It is reported that they were known during the years after World War I, at which time some Insurance Departments refused to recognize them.

The laws of some states require approval by the Insurance Commissioner of reinsurance contracts affecting more than a stated percentage of a company's total outstanding risks. Guaranteed profit contracts often affect lesser percentages.

When during the course of an examination, or in some other manner, a guaranteed profit contract is encountered,

there arises the question of the proper reserve to be established. The measure of such reserve or liability has been the subject of considerable debate, but it is difficult to support logically the use of any reserve less than the amount of the full unearned portion of the tentative commissions originally received. This procedure would offset any surplus benefit arising out of the guaranteed profit contract. The establishment of a reserve for the possible payment of return commissions on the basis of the company's estimated loss ratio, as indicated by previous years' experience, or otherwise, would not be sufficient because its use would not only anticipate in advance the full unrealized profit hoped to be earned on the business, but would ignore elements of future expense and possibly fail to provide for future losses and unallocated loss adjustment expenses incurred. This method is not consistent with the American practice of establishing the reserve on the basis of gross unearned premiums, except when the *risk* had been transferred to a reinsurer.

Companies are not permitted to take credit in their financial statements for any so-called "equity" in the unearned premium reserves. It is ironic and inconsistent to allow such credit to a company merely because it has gone through the motions of a guaranteed profit contract and further depleted its assets by the amount of the reinsurer's fee. If credit for such "equity" is to be granted it should be granted directly, which in most states would require a change in present laws and practices with respect to gross unearned premium reserve requirements.

A Special Type of Surplus Aid Contract

During the course of this study, consideration was given to a certain interesting type of contract that might be classed as a "surplus aid" contract but differed in several main particulars: (1) It was couched in ambiguous language, undoubtedly intended to confuse, with respect to reinsurance premiums, commissions, and settlements. (2) It was actually an excess of loss contract,

with the typical deposit premium paid at the beginning of the contract period, with annual settlements at the end of each calendar year on an earned premium basis. (3) Unlike the usual "surplus aid" contract, which increases the surplus of the ceding company by the amount of tentative reinsurance commissions actually received, this contract attempted to abet the immediate increase (in advance) of the surplus of the ceding company by the amount of so-called "reinsurance commissions" to be computed at the end of the contract year on an earned premium basis. (4) These so-called reinsurance commissions were actually not reinsurance commissions at all, but were merely referred to as such in the contract. The minimum "reinsurance commission" rate was specified as 25% of the original premium. The patent impossibility of this rate was revealed by the fact that the net reinsurance premium rate (obviously a judgment rate) was determined by analysis to be actually only 4% of the original premium, or much less than the amount of the so-called reinsurance commission.

Although the above contract is an extreme example of what might be encountered, it must be borne in mind that no reinsurance contract can rightfully endow a ceding company with the privilege of directly or indirectly claiming credit against its unearned premium reserve with respect to risk that has not actually been transferred to the reinsurer. The real measure of the transfer of risk in connection with the above contract is 4% of the original earned premiums, and the maximum credit against the company's unearned premium reserve should be the unused portion of its deposit premium, the same as in the case of any other excess of loss contract. Any other interpretation is in direct contravention of American statutory and accounting requirements for a gross unearned premium reserve.

Ordinary "Sliding Scale" Contracts

A large portion of reinsurance business is written on a "sliding scale" or "profit commission" basis, so that if the ceded business is profitable, the ceding company

will receive additional commissions from the reinsurer. There is no criticism of this provision, [B17] with the understanding that no credit shall be taken for such contingent commission until the loss ratio has actually been developed and the additional commission, if any, has thus been earned. If analysis reveals the contract to be merely an excess of loss ratio, or stop loss contract, it should be handled the same as other excess of loss contracts.

Some sliding scale contracts provide for possible return commissions up to 5% of the reinsurance premiums ceded. The reinsurer has usually paid a higher rate of tentative commission because of the provision for possible return commissions. The effect is the immediate (possibly temporary) inclusion of the differences in surplus of the ceding company. There is no objection to this type of contract, provided that the possible return is commission fully reserved, so that the actual credit claimed is limited to the guaranteed commission.

V. *The Question of Commissions Paid to Brokers for Obtaining Reinsurance for Insurers When Such Brokers or Brokerage Concerns Are Owned by Officers or Employees of Such Insurers and When They Collect Commissions for Obtaining Such Reinsurance When Their Services Appear to Be of Little or No Value.*

Most European reinsurance is written through reinsurance brokers who receive commissions for their services based on the reinsurance premiums written. These commissions are usually paid by the reinsurer. Reinsurance commission rates vary from $\frac{1}{2}\%$ to $2\frac{1}{2}\%$ on surplus line or quota share treaties, and from 5% to 10% on excess of loss treaties.

All business placed with Underwriters at Lloyd's, London, must be written through a Lloyd's broker, who must be a British citizen. Lloyd's representatives in the United States also receive commissions in American business.

In the United States, the services of reinsurance brokers, or intermediaries, as they prefer to be called,

are available to companies desiring such services. We understand that only a small percentage of American fire reinsurance and practically no American casualty reinsurance is written through reinsurance brokers. Commission rates are said to be lower than those in Europe.

It is not the usual practice for an officer or employee of an American insurance company to receive, directly or indirectly, a commission on the reinsurance to which his company is a party. If such a commission represents a secret payment it is undoubtedly illegal on the basis of the common law.

VI. *The Question of Whether In Making Examination of Insurers More Information Should Not Be Developed with Reference to Reinsurance Contracts and Such Information Set Forth In Examination Reports.*

The importance of a program to be followed by examiners when reviewing reinsurance contracts cannot be overemphasized. There should be noted the essential features of the company's contracts which might be overlooked and could vitally affect a company's financial status.

A suggested program for the examination of reinsurance contracts follows:

1. *Coverage*—Type of contract, limits, underwriting restrictions, classes of risks, territory.
2. *Period covered*—Effective date, expiration date, cancellation provisions and notice required for cancellation. Disposition of unearned premiums or runoff of covered risks, if any, in the event of cancellation.
3. *Reporting and settlement requirements*—Are premium or loss bordereaux required? Information requirement for monthly or quarterly statements? When must settlements be made? Any provision for withholding?
4. *Reinsurance premiums*—If it does not follow the original premium, what is the rate and method of computation? Does it represent a specified percentage of the written or *earned* premium? Is there a deposit premium? Is the rate adjustable from year to year on an automatic basis, and if so, what is the procedure, the

loading, and the minimum and maximum rate? Is there any provision for retroactive adjustment?

[B18] 5. *Reinsurance commissions to ceding company*—What is rate of commission? Is there any contingent or profit commission? Is there any provision for possible return to the reinsurer of tentative commissions already received, and if so, how much? Has proper provision been made in the financial statement for such possible return?

6. *Insolvency clause*—See if this clause is included in the contract. If not, in certain states no credit can be allowed for such reinsurance.

Comment follows with respect to various examination problems concerning reinsurance.

Verification of Balances due to and from the Company's Reinsurers and Test Checks to Be Made of Operations Under Such Contracts

Verification should be made during the course of an examination of the reinsurance balances payable, funds withheld, unearned premium reserves on reinsurance ceded and reinsurance premiums in force, and losses recoverable on paid and unpaid losses.

Examiners of various insurance departments at times have followed the practice of confirming these items directly with the reinsurers. Because of practical difficulties, this procedure is not recommended for wide use. Reconciliation is frequently difficult because of the normal reporting lag between the books and records of the ceding company and those of the reinsurer. When large and important reinsurance credits are involved, direct confirmation may prove definitely advisable.

The most effective method of verification for general use is a thorough test-check of operations under the reinsurance contract, which will verify the accounting under such contracts and aid in the proper establishment of the balances at the end of the period. Reinsurance premiums payable can be checked against the written reinsurance premiums for the last month or months. Losses recoverable on paid losses can be verified against the payment of such direct losses. Losses recoverable on

unpaid losses can be verified in connection with the determination of the company's loss reserves. Reinsurance provisions can be determined from the contracts, but are often also indicated on claim files and on the daily reports. Funds withheld can often be checked through the accounting transactions of the period covered.

*Credits Against the Gross Premiums in Force and
Unearned Premium Reserve on Account
of Reinsurance Ceded*

The verification of the above usually presents no particular problems. It is essential only that the reinsurance premiums in force on reinsurance ceded be distributed to the proper terms and expirations and the proper unearned fractions be used for the determination of the unearned portion.

There is no allowable credit, however, against a ceding company's gross unearned premium reserve with respect to reinsurance ceded under the terms of a reinsurance contract not providing for a runoff of covered risks or the return of reinsurance premiums in the event of termination of the reinsurance contract. Most fire excess of loss contracts, as well as contracts providing for the determination of reinsurance premiums on the basis of earned original premiums, are of this type. The reinsurance premiums become expired in the same period as paid, and provide for current coverage only. Many such contracts provide for a deposit premium to be paid by the ceding company at the inception of the contract; and if there is any credit against the gross unearned premium reserve, it is equal to the unused portion of such deposit premium.

Deposit premiums are often either charged off as expense when paid, or set up for the policy term and expiration and credit taken for the earned portion. Neither of these methods ordinarily takes into consideration the accrued earned reinsurance premiums unpaid as of the date of the statement. Because deposit premiums usually are inadequate to cover the entire settlement period, both of the foregoing methods often result in understating

the company's liabilities. The proper credit, or asset value, of a deposit premium is equal to the unused portion of such deposit premium. This is determined by computing the earned reinsurance premiums to the date of the statement and comparing with the amount of the deposit premium. The unused portion of such deposit premium, if any, represents a proper credit. Any excess of earned reinsurance premiums over the amount of the deposit premium should be set up as a liability in the financial statement.

[B19] *Excessively High Rate of Reinsurance
Commissions Received by the Ceding Company*

Reinsurance commissions received by a ceding company represent reimbursement for all or part of its acquisition costs on the business ceded and usually bear a reasonable relationship to such costs. Typical examples of reinsurance commission rates are shown in the appendix to this report.

When a reinsurance premium rate represents a judgment rate, an excessive commission rate simply means that the gross reinsurance premium has been increased by the reinsurer to offset such excessive reinsurance commission, the net judgment rate for the business remaining as originally determined. The advantage to the ceding company is the attainment of larger credits against its unearned premium reserve, and in the casualty field materially reduces the Schedule "I" formula-basis reserves. Theoretically a company could by this method virtually wipe out its reserves. In practice the reinsurance commissions are rarely set over 50%, which produces a doubling of the reinsurance premium judgment rate. High commissions on such business should be carefully noted, and if necessary, the net credits reduced to reflect no more than a reasonable commission rate, if any.

*Reserve for Unallocated Loss Adjustment Expense
on Casualty Reinsurance Ceded*

Reinsurance contracts do not provide for the reimbursement by the reinsurer to the ceding insurer of unallocated loss adjustment expenses paid in the settlement of claims. Adequate provision should be made in the financial statement for payment of such unallocated loss adjustment expenses on a gross basis. Unallocated loss adjustment expense in a casualty insurer is a substantial item.

Complicated or Abtruse Contracts

The usual reinsurance contract is a relatively simple and well written document. Complicated or abstruse premium, commission, or settlement provisions are a cause for suspicion, and may indicate an intention not to carry out a legitimate reinsurance transaction but to confuse the regulatory authorities with respect to the temporary effect of the contract on the ceding company's surplus. The burden of proof should rest on the companies to explain the confusing provisions and to prove that such a contract anticipates the operation of a legitimate reinsurance relationship.

*Special Treatment to Be Accorded Treaties
Between Affiliated Companies*

When affiliated companies are not writing similar lines of business or are operating on the basis of different rate structures, it is important that the examiners look carefully into the equity of the reinsurance premium rates and reinsurance commission or expense reimbursement provisions of such contracts. These contracts have obviously not been entered into at arms length by disinterested parties. Unless a survey is made of the operating results of such inter-company reinsurance contracts, the most accurate and complete analysis of direct expense allocations is of little value.

Insolvency Clause

An insolvency clause in a reinsurance contract provides that in the event of the insolvency of the ceding insurer, the reinsurer will remain fully liable for its share. Examiners should note whether contracts contain this provision. A typical provision from the law of one of the states reads in part as follows: "No credit shall be allowed as an admitted asset or as a deduction from liability, to any ceding insurer for reinsurance made, ceded, or renewed unless the reinsurance shall be payable by the assuming insurer on the basis of the liability of the ceding insurer under the contract or contracts reinsured without diminution because of the insolvency of the ceding insurer" The insurance codes of California, Illinois, Louisiana, Massachusetts, New York, Utah, Vermont, Washington, and perhaps other states contain similar provisions. Texas requires it for fire companies and Iowa for domestic ceding companies. In the case of insolvency of the ceding insurer, when an insolvency clause is not included in the reinsurance contract, the reinsurer may be obliged to pay the receiver or liquidator only on the basis of payments actually made by the liquidator to the claimants, thereby increasing the degree of insolvency and loss suffered by the claimants. The advantage of the insolvency clause is apparent.

- [B20] VII. *The Question Whether It would Not Be Well to Request the Blanks Committee to Amend the Annual Statement Blank Form In Order to Allow Those Who Analyze Annual Statements of Insurers to Determine If an Insurer Has Attempted to Aid Its Surplus In an Unwarranted Manner by the Device of Reinsurance*

It is interesting to note that Alfred M. Best & Company, in its 1949 questionnaire to insurance companies for Best's Insurance Reports, asked for a copy of Schedule "F" if available, and requested information concerning unearned premium reserves on unauthorized reinsurance and changes in the company's reinsurance ar-

rangements during the year. The answers to these questions are necessary for a proper interpretation of the company's financial statement.

The answers to these questions are equally as important to the various Insurance Commissioners. The first step in achieving a universally acceptable method of handling unauthorized reinsurance and to disclose unwarranted increases in a company's surplus by the device of reinsurance is to provide in the Annual Statement blank for adequate information to be furnished all Commissioners. The object should be to supply information needed by the several Commissioners for appropriate action without the necessity of individual states requesting special forms to be filed.

The following forms are suggested for inclusion in the regular Annual Statement blank in the hope that they might furnish the information needed by the various Insurance Commissioners to determine whether the solvency of an insurance company rests on a solid foundation, or whether it is open to question because of the existence of surplus aid contracts, or rests ultimately on alien or other reinsurance of doubtful collectibility or soundness.

Schedule "F"

Schedule "F," which is now required by many states, should be made a part of the regular Annual Statement blank. It would be more useful if, in addition to showing reinsurance in force by company on reinsurance ceded, it were extended to show also the amount of unearned premium reserves. In addition, certain instructions and interrogatories could be entered at the bottom of the form so as to provide the necessary information concerning unwarranted increases in the company's surplus through the device of reinsurance. It is reasonable to believe that publicity concerning contracts affording temporary surplus relief would discourage the use of such contracts.

A suggested revised Schedule "F" to be included in the regular Fire and Miscellaneous (Casualty) Annual Statement blanks filed with all states follows:

Schedule "F"

*Ceded Reinsurance in Force and Unearned Premium
Reserves as of December 31*

<i>Name of</i>		
<i>Reinsurer Location</i>	<i>Force</i>	<i>Unearned Premium Reserves</i>
Totals	<hr/>	<hr/>

(a) Designate with an asterisk (*) any reinsurance ceded under the terms of a contract providing that if aggregate losses exceed certain predetermined amounts or percentages the company may be required to pay to the reinsurer return commissions or retroactive increases in reinsurance premiums. Show the maximum amounts payable under the most adverse interpretation of such provisions.

(b) If any of the company's ten most important reinsurance contracts, in terms of reinsurance premiums in force, became effective during the current year, show the effective dates.

(c) If either instruction (a) or (b) is applicable to only a portion of the reinsurance ceded to a single reinsurer, show each portion separately.

(d) Has the company taken credit in advance for any reinsurance commissions not yet received? If so, explain.

Statement of Funds Withheld

A suitable form of "funds withheld" statement should be devised for inclusion in the Annual Statement blank to be filed with all states. The statement should show, by reinsurer, the unearned premium reserve on reinsurance ceded, losses recoverable on paid and unpaid losses, and as offsets, the funds withheld from, and due to, each reinsurer. The statement of "funds withheld" should also take into consideration the balances resulting from reinsurance accepted from unauthorized insurers. Any net unsecured balances due from non-admitted alien reinsurers and other balances of doubtful validity should be set up as a liability in the financial statement filed with the Insurance Commissioner.

A suggested form of "funds withheld" statement follows:

Company	Reinsurance Ceded				Net Re- insur- ance
	Gross Unearned Premiums	Paid and Unpaid Losses Recoverable	Funds With- held from Reinsurers	Miscel- laneous Balances	
	Debit	Debit	Credit	Dr. or Cr.	
Totals					

Denote with an asterisk (*) all balance which a liability has been set up a

Funds Withheld" Statement

Reinsurance Accepted				Net Bal- ance	Net Short- ages
Gross Unearned Premiums	Ceded Loss Reserves	Funds With- held by Ceding Companies	Miscel- laneous Balances		
Credit	Credit	Debit	Dr. or Cr.		Dr.

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clude to the following: (1) All alien reinsurers
branches subject to regulation by some state
Lloyd's, London; (2) Lloyd's, London; (3) The
authorized American reinsurers with respect to
the financial statement.

ces in the "Shortage" column, with respect to
the liability page of the financial statement.

B21

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[B22] *Schedule "E"—Miscellaneous Blank*

Schedule "E" of the Miscellaneous (Casualty) blank, which shows reinsurance recoverable on paid and unpaid losses from each reinsurer, should be extended to include another column showing the reinsurance recoverable on unpaid losses on the Schedule "P" lines of workmen's compensation and liability. This would show a more complete picture with respect to any reinsurer. Schedule "E" of the Fire blank needs no revision as it already shows all reinsurance recoverable on paid and unpaid losses.

*Possible Additional Information to Be Required
in Connection with Reinsurance Accepted*

In preceding section VI it was pointed out that there may be definite value in a check against the records of, or against a confirmation received from the reinsurer. Insurance Department statement analysts could make general checks of credit claimed for reinsurance ceded against information filed by reinsurers if a schedule showing reinsurance assumed in force, and unearned, similar in form to Schedule "F" were filed for reinsurance assumed. Some benefit might also be obtained as a result of showing amounts of reinsurance losses payable, by company.

As professional reinsurers must wait until they receive information from ceding companies in order to establish reserves before making up their Annual Statements, it might be well to give consideration to the possibility of an extension of the filing date for their Annual Statement to April 1. Such an extension would make possible a more complete inclusion of December transactions. Delaying the filing date for reinsurers would be particularly desirable if further requests for detail were made of them.

Conclusion

Reinsurance is an indispensable tool in the continued operation of the insurance business, and is usually trans-

acted in an atmosphere of genuine good faith and mutual trust. It is unfortunate that it has been misused by a few companies.

Previous suggestions appearing in the text of the report are summarized for the purpose of outlining steps which might be taken to cure existing abuses.

*Question of the Allowance of Credit for
Non-Admitted Reinsurance*

1. There is considerable diversity in the state laws regarding allowance of credit for non-admitted reinsurance. The need for greater uniformity is obvious.

2. An increase in the emphasis placed on the actual value of ceded reinsurance is necessary to protect the policyholders against danger of insolvency.

3. The judicious and resolute exercise of the discretionary power of the various Commissioners with respect to unacceptable non-admitted reinsurance appears to be essential for successful regulation.

4. Particular attention should be given to reinsurance placed with companies in states not exercising reasonable control over reinsurance and retrocessions in order to avoid the perils inherent in a reinsurer being used as a conduit for the admission of otherwise unacceptable reinsurance.

5. There appears to be a commendable trend in state laws and practices toward the elimination of the requirement of admission of the reinsurer in the state as the condition precedent to acceptability for credit.

*Question of the Allowance of Credit for
Alien Reinsurance*

1. Credit should not be allowed for reinsurance ceded to non-admitted alien reinsurers except:

- a. Up to the amount withheld from such reinsurer, or deposited by such reinsurer, and under the control of the ceding company.
- b. When there are trustee funds in the United States in excess of liabilities and under proper supervision.

2. Special consideration for Lloyd's, London. See comment under Section II.

[B23] *Non-risk-transferring reinsurances*

1. The transfer of risk from the ceding company to the reinsurer is the essential element of every reinsurance contract.

2. Surplus aid contracts do not provide, except sometimes nominally, for the transfer of risk, even though the ceding company has taken credit in its financial statement for the cession of such risk.

3. American statutory and accounting standards require an unearned premium reserve to be established on a gross basis, pertaining to all net business at risk.

4. When reinsurance contracts involve the possible subsequent repayment of tentative commissions by the ceding insurer, there should be allowed credit only for the guaranteed portion of the commission received, regardless of the estimated loss ratio.

5. Contracts entered into before year-end and cancelled shortly thereafter may indicate lack of bona fide intent to reinsure.

Sections VI and VII of the Report

These sections include comments recommended for the consideration of the Committee on Examinations, and the Committee on Blanks, respectively, of the National Association of Insurance Commissioners.

Respectfully submitted, A. C. Escherich, Principal Examiner, California Department of Insurance, Chairman; Georgia L. Harvey, Principal Examiner, Massachusetts Department of Insurance; Ernest D. Gerye, Senior Examiner, Nebraska Department of Insurance.

APPENDIX

Definitions

"Reinsure" is defined in Webster's New International Dictionary, Second Edition, Unabridged, "to insure again, to transfer to another insurance company the liability, in whole or in part, assumed by the direct writing company; also to assume the liability, in whole or in part, of an insurance company which is already covering the risk."

"Reinsurance transaction" is defined by C. E. Goldin in his 1948 edition of "The Law and Practice of Reinsurance" as follows: "A reinsurance transaction is an agreement made between two parties, called ceding company and reinsurer respectively, whereby the ceding company agrees to cede and the reinsurer agrees to accept a certain fixed share of a risk upon terms as set out in the agreement."

"Reinsurance" is defined in the Insurance Codes of the several States and Commonwealths of the United States. Transfer of risk or liability from the ceding company to the reinsurer is the gist of each definition. A typical definition is as follows: "A contract of reinsurance is one by which an insurer procures a third party to insure it against loss or liability by reason of such original insurance."

"Retrocession" is explained in "Reinsurance—Its Practice and Principles" by E. M. Sturhahn, and edited by W. J. Langler, as follows: "A retrocession is the reinsurance of a reinsurance. If a reinsurer wishes to give off a share of a cession or cessions which have been ceded to it, it is said to retrocede, i.e. to cede again, or to pass on a reinsurance (or a part thereof) to another reinsurer. The reinsurer accepting the retrocession is called a retrocessionaire."

Historical Notes on Reinsurance

The first reinsurance contract on record was effected in the year 1370 when an underwriter contracted to reinsure a ship on part of its voyage from Genoa to

Bruges. He retained at his own risk that part of the voyage through the Mediterranean, and transferred the risk on that part of the voyage from Cadiz through the Bay of Biscay and along the French Coast. Reinsurance practice was later mentioned in the "Antwerp Customs" of 1609 and the marine regulations published at Bordeaux in 1647 and at Rouen in 1671, which represented consolidations of the "Guidon de la Mer," a code of sea laws in use in France from a very early date.

With the shift of commerce to the north of Europe and the inception of Lloyd's sometime prior to 1710 there followed also a shift in marine insurance activity, principally to England. Subsequently many underwriters began writing marine policies and reinsuring parts of such policies with others, who often in turn retroceded at still lower [B24] rates. This practice resulted in the statutory prohibition in Britain in 1746 of the practice of reinsurance, which prohibition was not repealed until 1864 by which time it had become more or less a dead letter.

Development of reinsurance in the modern sense may be credited primarily to the fire insurance business. In the early days of the fire insurance business, most fire insurance policies were quite small and were written by mutual companies that were able to assess their members when losses occurred, and therefore did not feel the need of reinsurance. Industrialization and the growth of areas of concentrated hazard and large individual risks, as well as the appearance of stock companies in the fire insurance field, prompted the first reinsurance practices, which were on a facultative basis.

The first obligatory or automatic reinsurance treaties apparently were effected in Germany shortly after 1820. In 1824, a British company entered into a reinsurance agreement with a French company, and it is interesting to note that a century later this treaty was still in effect. However, for the first half of the 19th century, most reinsurance continued to be on a facultative basis, mostly with direct writing companies, and often on a reciprocal basis. The first specialized or professional reinsurance companies were developed partly because of the reluctance of direct writing companies to reinsure their risks

with other direct writing companies competing for the same business.

The first independent reinsurance company was founded in 1846—the Cologne Reinsurance Company—which finally with the assistance of considerable French capital succeeded in greatly extending its operations on an international basis. There followed the organization and expansion on the European Continent of numerous other reinsurance companies, many of which engaged in an extensive international business, including business in the United States. The first reinsurance company to be organized in the United States was the First Reinsurance Company of Hartford, which was incorporated in 1912.

World War I caused the retirement of many of the German reinsurance companies and created a great shortage in reinsurance facilities resulting in the substantial expansion of reinsurance facilities in Switzerland, Great Britain, the Scandinavian countries and the United States.

A reading of literature on the subject of reinsurance cannot but impress upon the reader the benefits to be derived from the absorption through worldwide reinsurance of shock losses caused by catastrophes and losses resulting from major random and cyclical fluctuations, many of which are of a local nature. International reinsurance proved its worth not only in the repeated conflagrations of the 19th century, but also at the time of the San Francisco fire of 1906, and in various more recent catastrophes, including the Texas City disaster in 1947.

Notwithstanding the spread afforded by the geographical size of the United States, there is still the need for the facilities offered by international reinsurance. A well informed executive in the fire reinsurance business recently estimated that 60% of American fire excess of loss reinsurance is presently being placed with Underwriters at Lloyd's, London, and that most of the remainder is being written by a single American Company and by a large American underwriting pool.

Today there appears to be less probability of the destruction of large cities by fire, but there are other hazards that fire underwriters speak of with apprehension, such as the hurricane hazard, the earthquake hazard, and the hazard of large industrial or warehouse fires.

Casualty reinsurance has recently been exposed to new and increasing hazards such as the large workmen's compensation losses resulting from single occurrences, the large judgments and awards on third party automobile liability cases, and the unknown hazards faced in connection with general liability. Oil production, industrial fumes, explosions, processing of new products, and products liability can all be the cause of large losses affecting the interest of the reinsurer.

Aside from the benefits derived from the spreading of risk, reinsurance affords underwriting capacity to the smaller insurance companies in the business and is a very important factor in the maintenance of their competitive positions.

Current Reinsurance Volume

Best's Fire and Casualty Aggregates and Averages, Tenth Edition, shows the following premiums written by professional reinsurance companies during the year 1948:

[B25] FIRE REINSURANCE

14 domestic stock fire carriers	\$37,492,668
8 United States fire branches	36,712,331
7 foreign owned stock carriers	14,260,610

CASUALTY REINSURANCE

10 stock casualty companies	\$91,748,495
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Stone & Cox's Accident, Fire and Marine Insurance Yearbook, published in London in 1949, estimates that worldwide there are approximately 150 professional reinsurance companies. No estimate is given of their total annual premium volume. There is no practicable way of

estimating the amount of reinsurance written annually in the United States by non-admitted alien reinsurers.

The preceding figures represent the net premium writings of professional reinsurance companies only. They do not, therefore, include any of the reinsurance premiums accepted by insurance companies engaged primarily in the direct writing of insurance. From the earliest days of reinsurance, many direct writing companies ceding facultative reinsurance to other direct writing companies demanded that they receive in exchange comparable amounts of reinsurance. This practice is known as "reciprocity" and exists today not only with respect to facultative reinsurance but also with respect to treaty reinsurance. There are some companies that are primarily direct-writers, but also accept a considerable volume of reinsurance premium, either directly or through various underwriting pools. However, most of the reinsurance accepted shown on the financial statements of direct writing companies operating as members of "fleets" or "groups" actually represents inter-company sharing, on a quota-share basis, of the writings of the group, and therefore is quite different from outside reinsurance. Since no ready separation can be made of the inter-company reinsurance from outside reinsurance accepted by direct writing companies, the figures lose their statistical significance.

Forms of Reinsurance Contracts

Any summary of the different forms of reinsurance contracts should be prefaced with the observation that flexibility is one of the outstanding characteristics of the reinsurance business and that in practice no two reinsurance contracts are exactly alike. Occasionally contracts will be encountered that cannot be readily classified.

Fire Reinsurance

Fire reinsurance contracts are of two general classes—facultative and treaty. Facultative or specific reinsurance is the original type. Facultative treaty and semi-faculta-

tive treaty are in effect but variations of facultative reinsurance.

Fire treaty reinsurance provides for the automatic cession of certain risks or parts of risks on a mutually obligatory prearranged basis. Surplus and quota share treaties provide for pro rata sharing of risks between the ceding company and the reinsurer. Excess of loss reinsurance provides for no sharing of losses as such, but the payment by the reinsurer, after certain stipulated retentions have been paid by the ceding company, of the excess of loss on individual policy claims, or what is more usual, excess of over-all loss resulting from single occurrences. Excess of loss ratio, or stop-loss, is a form of excess of loss.

Facultative or Specific

This type of coverage has been likened to over-the-counter direct brokerage business. It is sometimes referred to as "street reinsurance." It is transacted one risk at a time, and each cession is optional to both the ceding company and the reinsurance company, which may frequently be another direct writing company. Facultative business is often regarded as basically sub-standard because of the possible adverse selection and is consequently underwritten by the reinsurer with at least the same care as direct business. It is sometimes used because additional capacity may be required over that offered by treaty facilities. The reinsurance premiums on facultative contracts usually follow the original premiums written, and the reinsurer follows the fortunes of the ceding company with respect to its portion of the risk. Reinsurance commissions are usually paid at the rate of 30 or 35 per cent.

[B26] The mechanics of handling facultative reinsurance are simple, but if any great volume is handled, may prove somewhat expensive. A binder or reinsurance slip is prepared by the ceding company and taken by a placer to the prospective reinsurer or reinsurers who initial the slip and thus bind themselves on their agreed portion of the risk. The reinsurer subsequently issues a certificate or policy and bills the ceding company for the reinsurance

premium less the commission, the balance becoming payable within a period of 30 to 90 days.

Facultative treaty

This is an agreement between two insurance companies providing the general terms under which facultative reinsurance is to be ceded. Each risk is still optional to both the ceding and the reinsuring companies, and there is no obligatory feature. Such a treaty may be entered into between two companies ceding business to each other on a reciprocal basis.

Semi-facultative treaty

This differs from the facultative treaty in that although cessions are optional to the ceding company, acceptance of the risk is obligatory insofar as the reinsurer is concerned. General agency reinsurance is usually of this kind. It is essentially the same as the "open cover."

Surplus treaty

This is the most usual type of fire reinsurance treaty in use today. Under a surplus treaty, an insurance company cedes portions of individual risks when its insurance on those particular risks exceeds the company's desired net retention, as provided in the reinsurance contract.

A typical first surplus treaty specifies the territory, the class or classes of business to be covered, the minimum net retentions, and the proportion or proportions which the reinsurance ceded is to bear to the risk retained on each risk, expressed in terms of even multiples. Reinsurance premiums follow the original premiums, e. g., if the amount ceded is equal to twice the net retention, the reinsurance premium shall also equal twice the premium retained, or two-thirds of the gross. For example, the net retention of the ceding company with respect to a \$6,000 risk could be \$2,000 and the cession equal to twice the retention.

The important thing about surplus reinsurance is that it is pro rata reinsurance based on the automatic cession

of surpluses of individual risks. Each and every loss pertaining to a reinsured risk, regardless of the size of the loss, is shared by the reinsurer. In the preceding example if there were a total loss of \$6,000, the ceding company would recover \$4,000 from the reinsurer, thereby sustaining a net loss of \$2,000. If there were a loss aggregating only \$6, the ceding company would recover \$4 from the reinsurer. Computation is facilitated by the exact multiples used in surplus treaties.

Occasionally several reinsurers may share in the first surplus, either on a "line" basis or on a percentage basis. Each reinsurer takes a predetermined portion of the surplus pool.

For additional capacity above the first surplus, companies make use of second and third or sometimes even higher surpluses.

Reinsurance premiums on surplus treaty reinsurance are ordinarily on a written basis. In the event of expiration or cancellation of the treaty, the contract provides for the continued liability of the reinsurance company on those risks reinsured until their expiration, i.e., until the runoff of such business. Liability may be terminated sooner by mutual agreement and the return of the unearned reinsurance premium. Contracts frequently are continuous, with 60 or 90 day cancellation clauses.

Commissions to the ceding company usually bear a reasonable relationship to the acquisition costs of the direct writing company, and have been estimated to cover a range of anywhere from 25 to 45 per cent on this type of contract.

As the result of a trend becoming accentuated about 1943, about three-fourths of surplus treaties are now written on a "sliding scale" commission basis. Most of these contracts provide for a flat commission ranging from about 30% to 37½%, paid on a written basis. Additional profit commissions are paid at a later date on an earned basis as specified by a formula embodied in the contract. These profit commissions are paid as the result of savings in the loss ratio. A common provision is that ½% profit [B27] commission shall be paid for each 1% saving in the loss ratio. Sometimes a portion of the

scale may provide for a "1 for 1" profit commission, i.e., a full 1% profit commission for each 1% saving in the loss ratio.

For example, a contract may provide for a flat commission of 35%, with a " $\frac{1}{2}$ for 1" profit commission to be paid the ceding company for any saving in the loss ratio under 55%, until the profit commission reaches 10%, or a total commission of 45%.

Some contracts provide for a possible "return commission." In the preceding example, if the loss ratio should exceed the breaking point of 55%, then the ceding company might have to pay a return commission to the reinsurer on a " $\frac{1}{2}$ for 1" basis until return commissions of, say, 5% have been returned, thus reducing the ultimate net commission from 35% to 30%. If the loss ratio should run under 35% or exceed 65%, then such saving or loss would ordinarily be carried forward to the computation for the following year. Contracts calling for possible return commissions are not numerous. None of this type were encountered that provided for possible return commissions in excess of 5%.

Quota share treaty

In quota share reinsurance, the reinsurer shares every risk in the class or classes reinsured on the basis of a fixed ratio determined upon beforehand. Premiums follow the original premiums, with the reinsurer receiving a share, expressed in terms of a specified percentage of the net premiums written. Commissions are paid to the ceding company on a flat percentage basis, but often with an additional profit commission. Quota share contracts written between affiliated companies may provide for reimbursement of acquisition costs, with or without additional over writing commissions, in lieu of commissions.

The most common use of the quota share principle in treaties is between members of a fleet of companies, who pool their business on a prearranged basis and usually provide in their reinsurance contracts with each other for reimbursement of expenses in exactly the same proportions as the premiums written. Generally, most expenses are paid by the parent company, and then allocated.

Another common use of the quota share principle is in the reinsurance pools, or clearing houses, through which companies reinsure special types of risks, such as surplus fire or aviation risks.

Quota share treaties have been found to be useful in solving the capacity problems of small or new companies whose experience may be untried or irregular and find it necessary to cede quota shares of their net retention of some or all lines until greater capacity and more seasoned experience can be developed. Commissions of from 25 to 45 per cent, sometimes augmented by profit commissions, may be paid by the insurer to the ceding company.

Portfolio reinsurance

Portfolio, or bulk, reinsurance provides for the cession to a reinsurer of all or part of the ceding company's liability with respect to its outstanding risks. The reinsurance premium is based on the unearned premium reserve and therefore is usually substantially less than the original premium on the business reinsured. Portfolio reinsurance is sometimes used in connection with a new quota share reinsurance treaty in order to put both outstanding and new premiums on the same basis. It is sometimes used by a ceding company for the purpose of retiring from certain geographical areas or lines of business. Commissions are paid the ceding company on a flat percentage basis, but often with an additional profit commission.

One purpose of portfolio reinsurance, encountered most frequently in affiliated companies, is to increase surplus. For example, if a company operating as a member of a group has been receiving 30% of the group's net writings and its share is decreased to 20%, the portfolio adjustment that is made on the effective date of the change entails a cession of one-third the company's entire portfolio. If the unearned premium transferred is \$1,000,000 and the expense reimbursement, or comparable commission, is equal to 45%, the company will pay to its affiliated companies the amount of \$550,000, rep-

representing the net reinsurance premiums on the transaction. Although the liability for unearned premiums is reduced by the amount of \$1,000,000, the cash account has been reduced by only \$550,000. The difference of \$450,000 is credited to reinsurance commissions received, and represents an immediate increase in surplus.

[B28] *Fire excess of loss treaty*

Fire excess of loss reinsurance is not a form of pro rata reinsurance, nor is there any sharing of risks as such. Only after a loss from a single occurrence exceeds a specified amount, and the ceding company has sustained the full amount of the loss or losses up to the amount of its retention, does the reinsurer become liable, and then only up to its limit. All losses amounting to less than its retention are paid in their entirety by the ceding company. Excess of loss reinsurance is available for successively higher limits from other reinsurers in layers, usually known as 2nd, 3rd, 4th, etc., excesses. Fire excess of loss contracts are sometimes referred to as castastrophe or conflagration covers.

Fire excess of loss reinsurance premium rate determination is largely a matter of judgment, based on the reinsurer's own experience, available statistics on the frequency and size of losses in the layer to be covered, the ceding company's experience, and its underwriting methods with respect to the size of individual risks and the degree of concentration of aggregate risks. Various mathematical formulas have been developed for the determination of pure premium rates for random and cyclical excess losses in various brackets, but it is apparent that such efforts are yet mostly on a theoretical basis and that even the statistical background for the development of such excess rates is as yet quite incomplete. From the point of view of the excess of loss reinsurer, if business is reasonably profitable over a ten year period, underwriting experience is regarded as satisfactory.

Reinsurance premium rates for excess of loss are usually stated in terms of a specified percentage of the

over-all net premiums written or earned in the class or classes covered by the treaty. Deposit premiums are usually required, frequently on an annual, but sometimes on a quarterly basis, subject to subsequent adjustment for the earned premiums actually developed. In some cases, particularly for the top layers, premiums may be quoted in terms of flat charges, without provision for subsequent adjustment.

Upon the expiration or cancellation of the usual fire excess of loss treaty, the coverage afforded by the treaty ceases, and there is neither a runoff of risks reinsured nor a return or reinsurance premiums to the ceding company. This is because excess of loss reinsurance premiums pay for current coverage only, and do not pay for future coverage. Deposit premiums are usually inadequate to cover the reinsurance premium for the entire period covered, and are often in an amount equal to the minimum premium for the contract.

Commissions to the ceding company are seldom paid on fire excess of loss reinsurance contracts.

Spread loss, "Carpenter cover," or "burning cost cover"

This cover is essentially an excess of loss form and was originally developed shortly after World War I by an American broker, Guy Carpenter, and written through Lloyd's, London, through which a substantial proportion of spread loss covers is still being written.

Usual excesses covered under spread loss contracts range from about \$50,000 in excess of \$5,000 for the smaller ceding companies up to about \$200,000 in excess of \$25,000 for the larger ceding companies. Excesses above the top limits are usually protected by catastrophe reinsurance.

The reinsurance premium rate, stated in terms of the percentage to be applied to the ceding company's net written or earned premiums, is based on the ceding company's own experience. Losses greater than average have the effect of increasing the rate in subsequent years, while losses less than average have the effect of reducing the rate in subsequent years.

The reinsurance premium rate for the first year usually is developed by taking the ceding company's net

premium income for the previous five years, summarizing those losses falling into the excess brackets selected and then computing the "burning cost" or "lost cost." The rate is then computed by multiplying the burning cost by the "loading factor," which may range from about 100/60 to 100/80.

The rate for the second year may be computed by dropping the oldest prior year, adding the first year covered by the contract, and multiplying the new burning cost by the specified loading. The third year rate is then computed by dropping the first two prior years, adding the first two years covered by the contract, and multiplying by the loading. The rate thus represents a five year loaded moving average.

[B29] Another method of computing the second and subsequent years' rates is to base the burning cost on the total of the entire period plus the experience under the contract, thus considerably modifying the effect of the experience under the contract. Still another method contemplates dropping the prior experience altogether, once the rate for the first year has been determined. This method of computing the second and subsequent years' rates can have an important effect on the ultimate net cost to the ceding company.

Maximum and minimum rates are specified in the contract. Sometimes the maximum is double the initial rate and the minimum is one-half the initial rate.

Spread loss contracts may be written for a period of five years on a virtually noncancellable basis, or they may be written on a continuous basis subject to a twelve months cancellation clause. Upon expiration or cancellation, there normally is no runoff, and coverage ceases, except in certain cases where an additional charge is made for such runoff. Consequently there can normally be no unearned premium reserve credit with respect to spread loss reinsurance ceded. Spread loss contracts do not provide for the payment of commissions to the ceding company.

Spread loss reinsurance has been the subject of considerable controversy in the insurance industry in recent years. Proponents point out that ordinarily its use

saves clerical labor, thus reducing operating expenses, results in a leveling of the loss curve over a period of years, and enables the ceding company to retain a larger proportion of its premium income than under other plans.

Opponents to the spread loss plan of reinsurance state that the principal objections from the viewpoint of the ceding company are the higher net costs resulting from the peculiar method of loading, the negligible immediate benefit to surplus, the risk inherent in the high net retentions, and the risk of excessive reinsurance premiums in future years under a contract that may be non-cancellable. High loss ratios in the early years make the contract more profitable to the reinsurer, with a higher ultimate net cost to the ceding company. In extreme cases, it might be advisable to provide an appropriate reserve in the financial statement.

Excess of loss ratio, or stop loss

This is a form of excess of loss treaty. It provides that the reinsurer will reimburse the ceding company for 90%, or some other proportion, of amounts by which its loss ratio exceeds a specified per cent of earned premiums. For example, the treaty may cover the amount in excess of 80% up to 120%. This form is not widely used, being adaptable mainly to lines having irregular experience from year to year, such as hail insurance. The stop should be fixed high enough to provide protection only in a bad year and not to guarantee a profit to the ceding company, but low enough to prove of some value. Accounting procedure is the same as for other excess of loss types.

Casualty Reinsurance

From an historical viewpoint, casualty reinsurance is a relatively modern development. Many of the principles of fire reinsurance also apply to casualty reinsurance. There is a tendency in the insurance business to separate widely fire from casualty reinsurance. Many insurance executives, expert in one field, insist they know nothing about the other.

Facultative, facultative treaty, and semi-facultative forms are used in connection with casualty reinsurance as well as with fire.

Share plan, or casualty pro rata, reinsurance

Share plan reinsurance, in casualty reinsurance terminology, is similar to surplus reinsurance in the fire field. In each case the reinsurer takes a fixed share of each risk reinsured and follows the fortunes of the ceding company. The amount of each retention is usually fixed in the treaty. The balance of each risk up to a specified limit represents the share of the reinsurer. Commissions paid to the ceding company depend on the quality of the business but bear a reasonable relationship to the direct acquisition costs.

Share plan reinsurance is used in connection with accidental death benefits, weekly benefit accident and health, burglary, fidelity and surety, and boiler and machinery.

[B30] *Casualty and excess of loss*

Casualty excess of loss reinsurance is written to cover workmen's compensation and employers' liability, auto liability and property damage, glass, and sometimes burglary.

Reinsurance premiums on the liability and property damage lines may be based on the manual charges to the direct assureds for such excesses. When the ceding company does not maintain adequate statistical and accounting records to supply the necessary information, the charge may represent a judgment rate. A judgment rate may be used as a matter of preference. In connection with workmen's compensation, glass, and burglary, where there is no additional manual charge to the direct assured for the excess protected by reinsurance, the reinsurance premium rate must necessarily be a judgment rate based on experience.

Commissions to the ceding company vary widely—anywhere from 0% to 50%, depending on the practice of the reinsurer and the type of coverage.

Treaty Reporting Methods

The older type premium bordereau which was handwritten or typed gave the cession number of each risk, policy number, name of the assured, location of the risk, amount insured, description of the property, such as class, original premium, retention of the ceding company, sum reinsured, reinsurance premium, and the term and rate. This painstaking type of premium bordereau was developed prior to World War I and was used by the reinsurer to carefully card and map its risks in order to keep its exposures under control, and as the source of detailed accounting information. Losses were reported in similar fashion, and the premiums, losses, commissions, and settlements summarized in monthly accounts.

In later years the necessity for reduction of clerical expense, as well as the improvement of machine accounting methods, prompted a reduction of reinsurance premium reporting detail until at present the majority of reinsurance contracts do not require bordereau and are on a straight account basis, usually monthly, but sometimes quarterly. These statements may show only totals, or they may contain summary totals of class, state, term, and expiration. When reinsurance bordereau are rendered under today's conditions, they are often in the form of tabulated lists. Reinsurance companies receiving such premium bordereaux, or sufficiently detailed statements of premiums, plus appropriate statements of losses advised and losses paid, may determine their own unearned premium reserve and loss reserve figures with respect to a certain ceding company's account. Otherwise, for the purpose of compiling their experience with respect to certain ceding companies, computing profit commissions, and preparing their own financial statements, reinsurance companies necessarily have to rely on statements from ceding companies for such items as reinsurance premiums in force, reinsurance premiums unearned, and outstanding losses.

In order to verify information received from a ceding company, the reinsurer has the right to audit or examine the reinsurance register, daily reports, and other pertinent records of the ceding company.

Surplus lines fire reinsurance has historically put most emphasis on complete premium bordereau. Some reinsurers reportedly still require complete bordereau on all their accounts. It appears, however, that few reinsurers require complete bordereaux on more than a third of their surplus lines reinsurance contracts. Bordereaux are most likely to be required from small companies, new companies, or from new accounts, in order to enable the reinsurer to keep currently informed with respect to the business being received.

Some types of treaty reinsurance such as fire excess of loss and most quota share or portfolio reinsurance do not often require the submission of detailed premium bordereaux. Such a bordereau would be tantamount to a full transcript of the company's business.

[B31] REINSURANCE SUBCOMMITTEE REPORTS

References

- 1949 Proc. p. 38 (Subcommittee to study reinsurance authorized)
- 1949 Proc. p. 366 (matters for further study)
- 1950 Proc. pp. 49-50 (additional matters for study)
- 1950 Proc. p. 447 (reinsurance study be referred to Blanks & Examinations Committees for concurrent study)
- 1950 Proc. pp. 448-452 (conclusions & recommendations to Blanks & Examinations Committees—report of 6/15/50)
- 1950 Proc. pp. 452-498 (technicians report dated 5/17/50)
- 1951 Proc. pp. 45; 48-59 (Subcommittee report of 6/15/50 amended by report of 12/10/50, further recommendations to Blanks Committee)
- 1951 Proc. pp. 481; 483 (Subcommittee reported that no meeting had been held)

- 1952 Proc. pp. 181; 182; 183-192 (Subcommittee reports of 11/21/51 & 12/2/51—paragraph 5 of 12/10/50 report amended; other proposed matters being studied)
- 1952 Proc. pp. 205; 206-207 (excess of Loss reinsurance separate reporting referred to Blanks Committee for implementation report of 12/4/51)
- 1952 Proc. pp. 403; 406-414; 435-436 (Subcom. report of 4/15/52 & 6/25/52 paragraph 5 amended & paragraph 7 amended; excess of loss reinsurance study continued)
- 1953 Proc. VOL. I, pp. 77 N.R.; 91; 93-106 (excess of loss reinsurance study reported by Blanks Com.)
- 1953 Proc. VOL. II, pp. 459; 485-498 (Blanks Committee reported that separate reporting of excess of loss reinsurance not feasible; review & further study on compliance by Lloyds, London)
- 1954 Proc. VOL. I, p. 78 (future meeting scheduled to further consider Lloyds, London, compliance with paragraph 5)
- 1954 Proc. VOL. II, pp. 415-416; 424-435 (majority & minority Subcom. reports tabled and question of credit on financial statements regarding reinsurance in Lloyds, London, be decided by the States; Subcom. discharged.)

[Number and Title Omitted]

[Filed: June 5, 1973]

JUDGMENT

The Court, Honorable Anthony A. Alaimo, United States District Judge, presiding, having tried this action without a jury on February 19, 1973 and having entered a Memorandum Opinion and its Order for the plaintiff on April 7, 1973, it is hereby

ORDERED, ADJUDGED and DECREED that the plaintiff recover of the defendant the following amounts for the years indicated together with statutory interest from September 9, 1969, plus costs allowed by law:

<u>Year</u>	<u>Deficiency</u>	<u>Interest</u>	<u>Total</u>
1961	\$25,340.29	\$11,205.44	\$36,545.73
1962	12,555.98	4,641.82	17,197.80
1963	17,494.51	5,288.77	22,783.28
1964	47,264.31	13,458.04	60,722.35

Entered this 1st day of June, 1973.

/s/ Anthony A. Alaimo
United States District Judge

Approved:

/s/ James R. Harper
JAMES R. HARPER, ESQUIRE
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By: /s/ Fred A. Luyties
FRED A. LUYTIES
Attorney, Tax Division
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Washington, D. C. 20530

[Number and Title Omitted]

[Filed: August 1, 1973]

NOTICE OF APPEAL

Notice is hereby given that the United States of America, defendant in the above-entitled action, hereby appeals to the United States Court of Appeals for the Fifth Circuit from the final judgment entered in this action on the 5th day of June, 1973.

R. JACKSON B. SMITH, JR.
United States Attorney

By: /s/ **Edmund A. Booth, Jr.**
EDMUND A. BOOTH, JR.
Assistant United States
Attorney

SUPREME COURT OF THE UNITED STATES

No. 75-1260

FIRST RAILROAD & BANKING COMPANY OF GEORGIA,
PETITIONER

v.

UNITED STATES

ORDER ALLOWING CERTIORARI

Filed May 24, 1976

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted. The case is consolidated with Nos. 75-1221 and 75-1285 and a total of one and one-half hours is allotted for oral argument.